

# **Chapter 6**

## **Audit Responsibilities and Objectives**

# Learning Objectives

- 1 Explain the objective of conducting an audit of financial statements and an audit of internal controls.
- 2 Distinguish management's responsibility for the financial statements and internal control from the auditor's responsibility for verifying the financial statements and effectiveness of internal control.

# Learning Objectives

- 3 Explain the auditor's responsibility for discovering material misstatements due to fraud or error, and the need to maintain professional skepticism when conducting the audit.
- 4 Classify transactions and account balances into financial statement cycles and identify benefits of a cycle approach to segmenting the audit.

# Learning Objectives

- 5 Describe why the auditor obtains a combination of assurance by auditing classes of transactions and ending balances in accounts, including presentation and disclosure.
- 6 Distinguish among the three categories of management assertions about financial information.
- 7 List the six general transaction-related audit objectives to management assertions for classes of transactions.

# Learning Objectives

- 8 Link the eight general balance-related audit objectives to management assertions for account balances.
- 9 Link the four presentation and disclosure-related audit objectives to management assertions for presentation and disclosure.
- 10 Explain the relationship between audit objectives and the accumulation of audit evidence.



Explain the objective of conducting an audit of financial statements and an audit of internal controls.

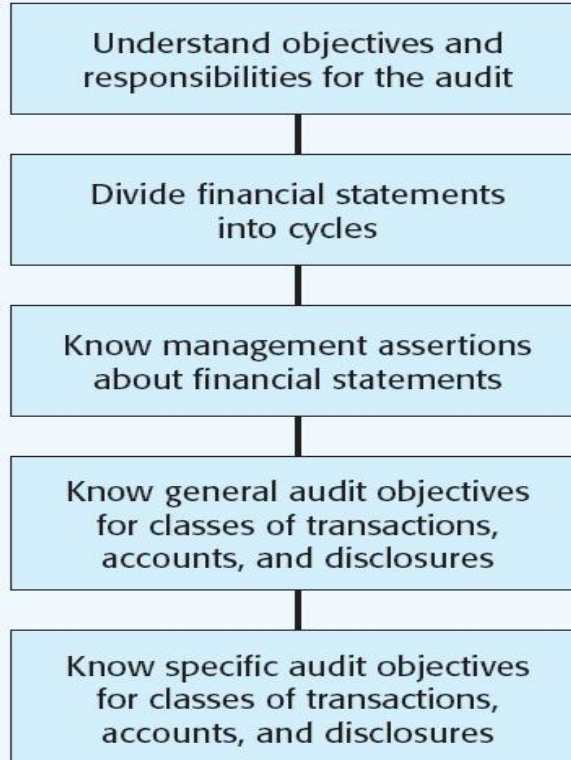
# Objective of Conducting an Audit of Financial Statements

The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with applicable financial accounting framework.

# Steps to Develop Audit Objectives

**FIGURE 6-1**

## **Steps to Develop Audit Objectives**





## 2

Distinguish management's responsibility for the financial statements and internal control from the auditor's responsibility for verifying the financial statements and effectiveness of internal control.

# Management's Responsibilities

Financial statements and internal controls.

Sarbanes-Oxley increases management's responsibility for the financial statements.

CEO and CFO must certify quarterly and annual financial statements submitted to the SEC.

# Management's Responsibilities

**FIGURE 6-2**

## **International Business Machines Corporation's Report of Management**

### **REPORT OF MANAGEMENT**

International Business Machines Corporation and Subsidiary Companies

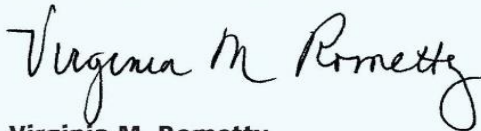
#### **Management Responsibility for Financial Information**

Responsibility for the integrity and objectivity of the financial information presented in this Annual Report rests with IBM management. The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, applying certain estimates and judgments as required.

IBM maintains an effective internal control structure. It consists, in part, of organizational arrangements with clearly defined lines of responsibility and delegation of authority, and comprehensive systems and control procedures. An important element of the control environment is an ongoing internal audit program. Our system also contains self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

[third and fourth paragraphs omitted]

The Audit Committee of the Board of Directors is composed solely of independent, non-management directors, and is responsible for recommending to the Board the independent registered public accounting firm to be retained for the coming year, subject to stockholder ratification. The Audit Committee meets periodically and privately with the independent registered public accounting firm, with the company's internal auditors, as well as with IBM management, to review accounting, auditing, internal control structure and financial reporting matters.



**Virginia M. Rometty**  
President and Chief Executive Officer  
February 28, 2012



**Mark Loughridge**  
Senior Vice President and Chief Financial Officer,  
Finance and Enterprise Transformation  
February 28, 2012

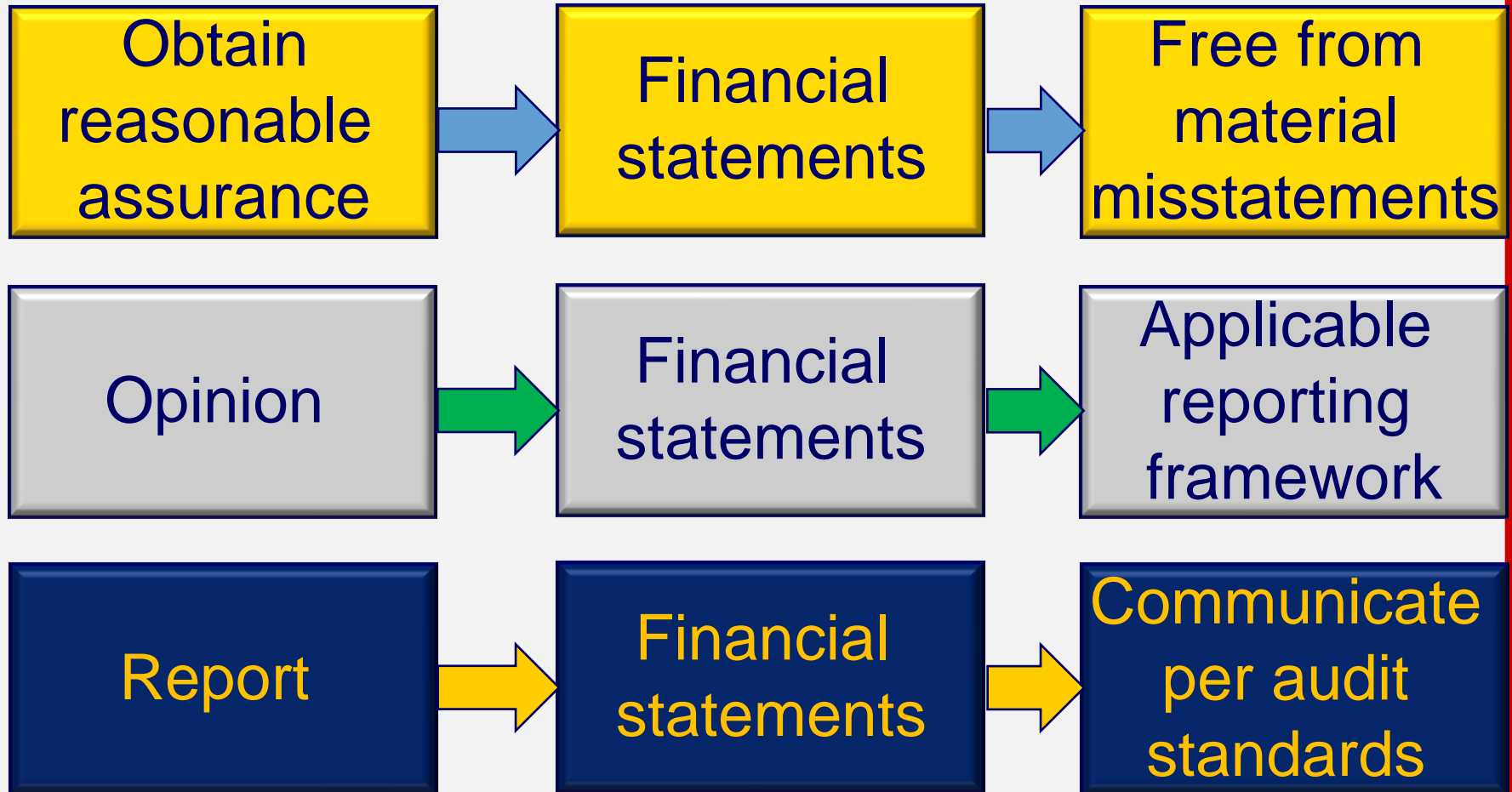
# Management's Responsibilities

The Sarbanes-Oxley Act provides for criminal penalties for anyone who knowingly falsely certifies the statements.

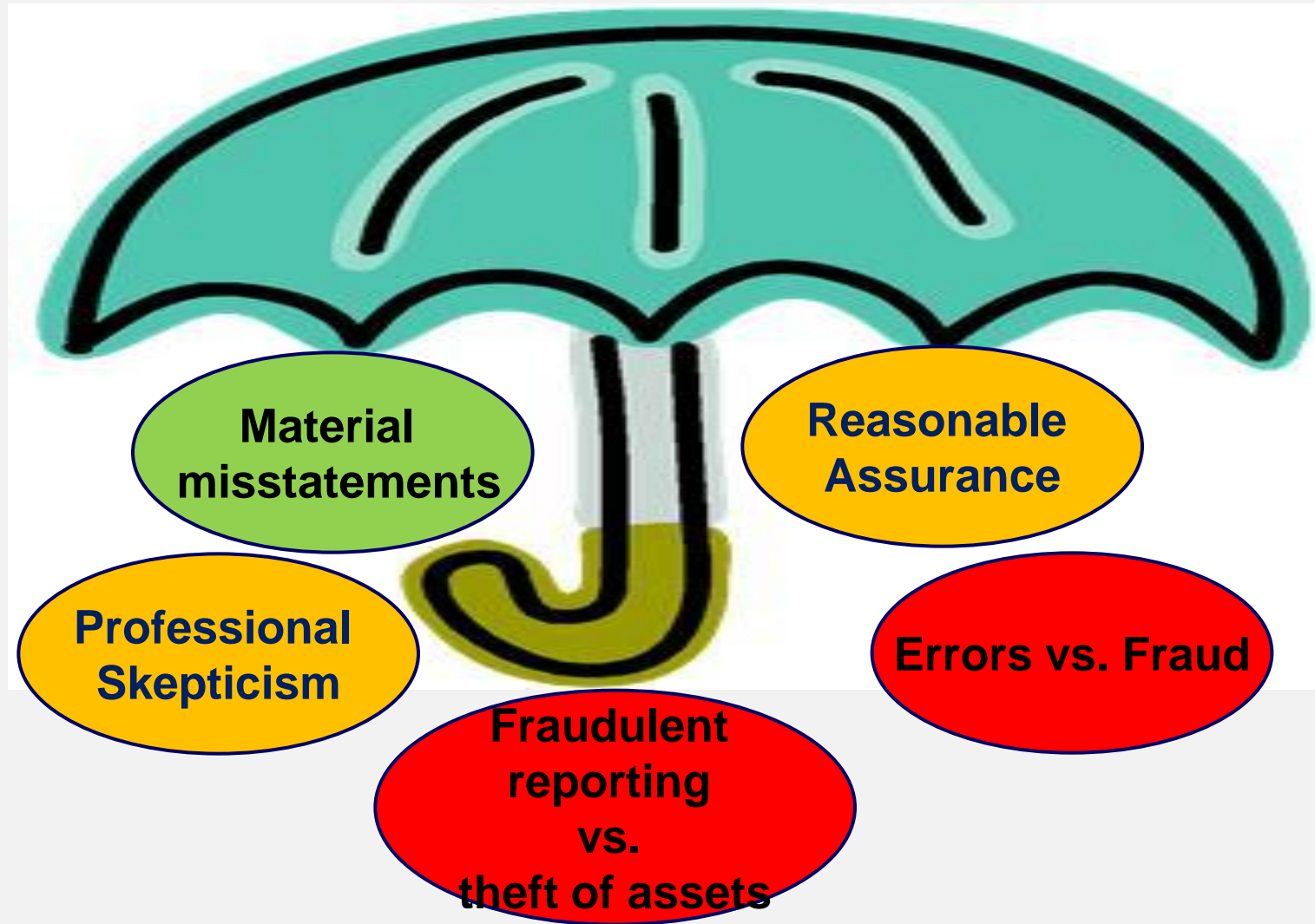
# 3

Explain the auditor's responsibility for discovering material misstatements due to fraud or error, and the need to maintain professional skepticism when conducting the audit.

# Objectives of the Auditor



# Auditor's Responsibilities



# Auditor's Responsibilities

## Why not absolute assurance?

**Reasonable Assurance**

1. Audit evidence depends on testing a sample of the population
2. Accounting disclosures contain complex estimates
3. Fraudulent financial statements are extremely difficult to detect

**Professional Skepticism**

a questioning mind

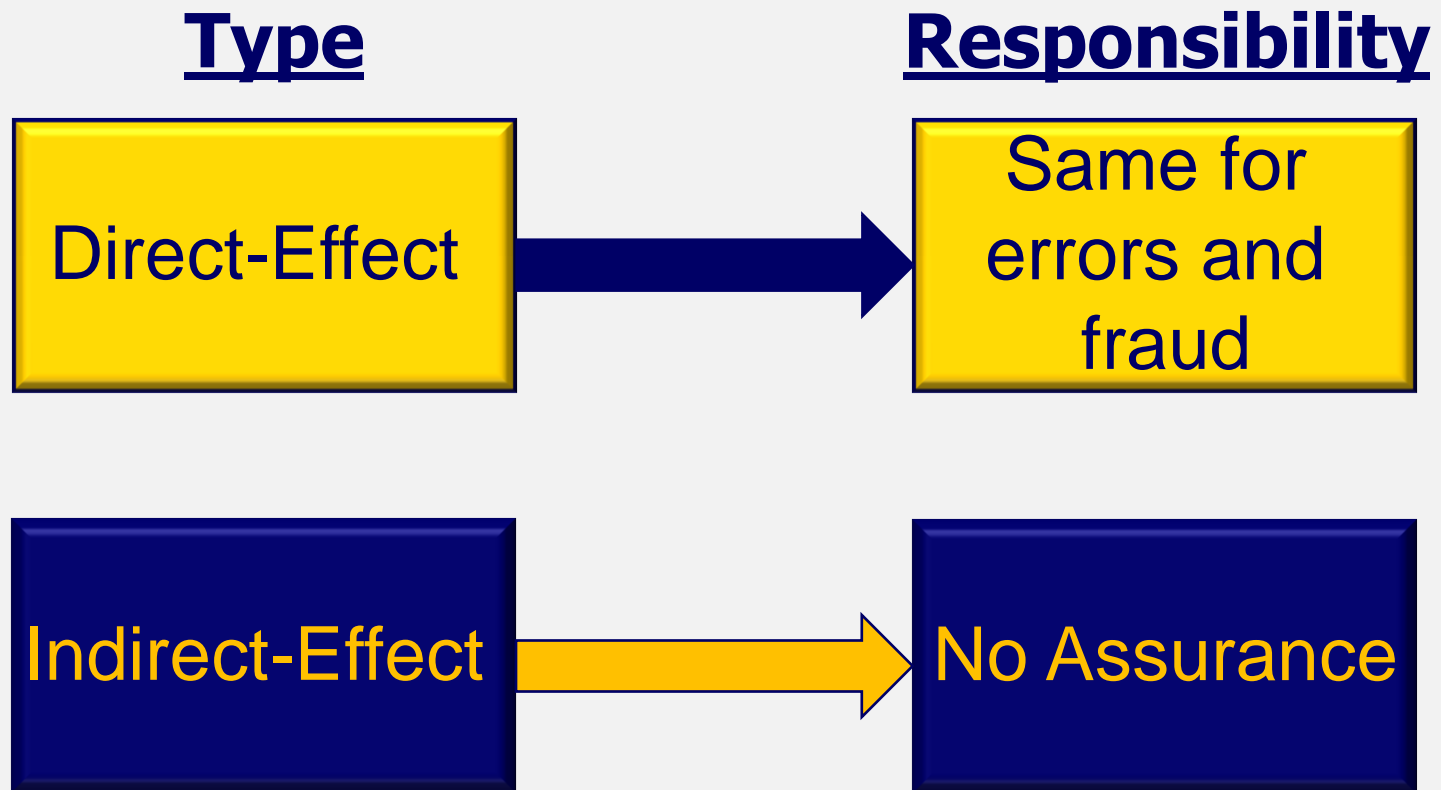
a critical assessment of the audit evidence

## What are the elements of PS?

1. Questioning mind
2. Suspension of judgment until evidence is obtained
3. Search for knowledge
4. Interpersonal understanding
5. Autonomy and independence
6. Self-esteem to challenge assumptions and resist persuasion



# Auditor's Responsibility to Consider Laws and Regulations



# Auditor's Responsibility to Consider Laws and Regulations

## Auditor suspects

- Inquire of management
- Consult client's counsel or specialist
- Consider accumulating evidence

## Auditor knows

- Consider effects on financial statements
- Consider effect on relationship with management
- Communicate with audit committee or equivalent



# 4

Classify transactions and account balances into financial statement cycles and identify benefits of a cycle approach to segmenting the audit.

# Financial Statement Cycles

Audits are performed by dividing the financial statements into smaller segments or components.

# Transaction Flow Example

**FIGURE 6-3**

**Transaction Flow from Journals to Financial Statements**

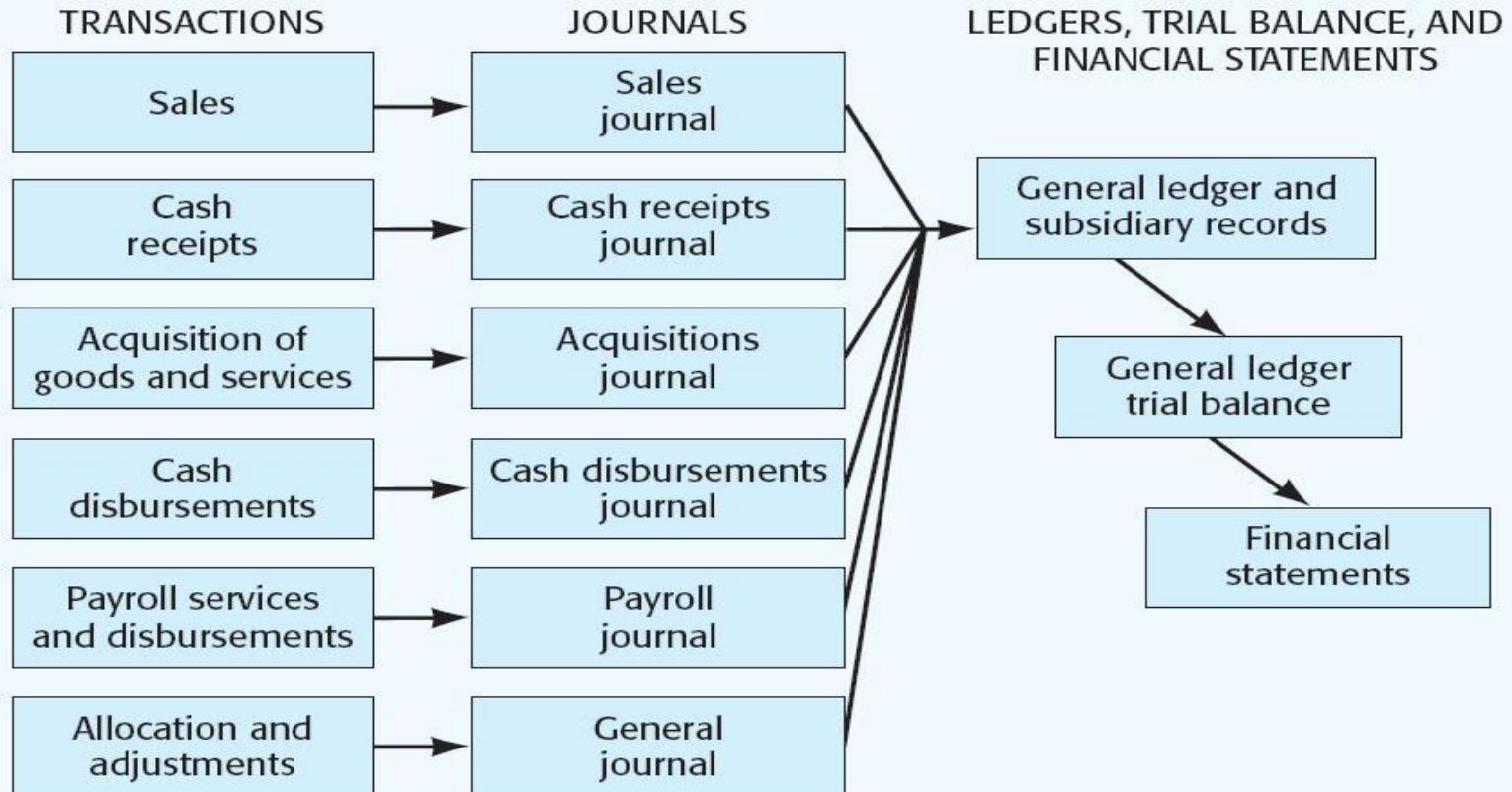


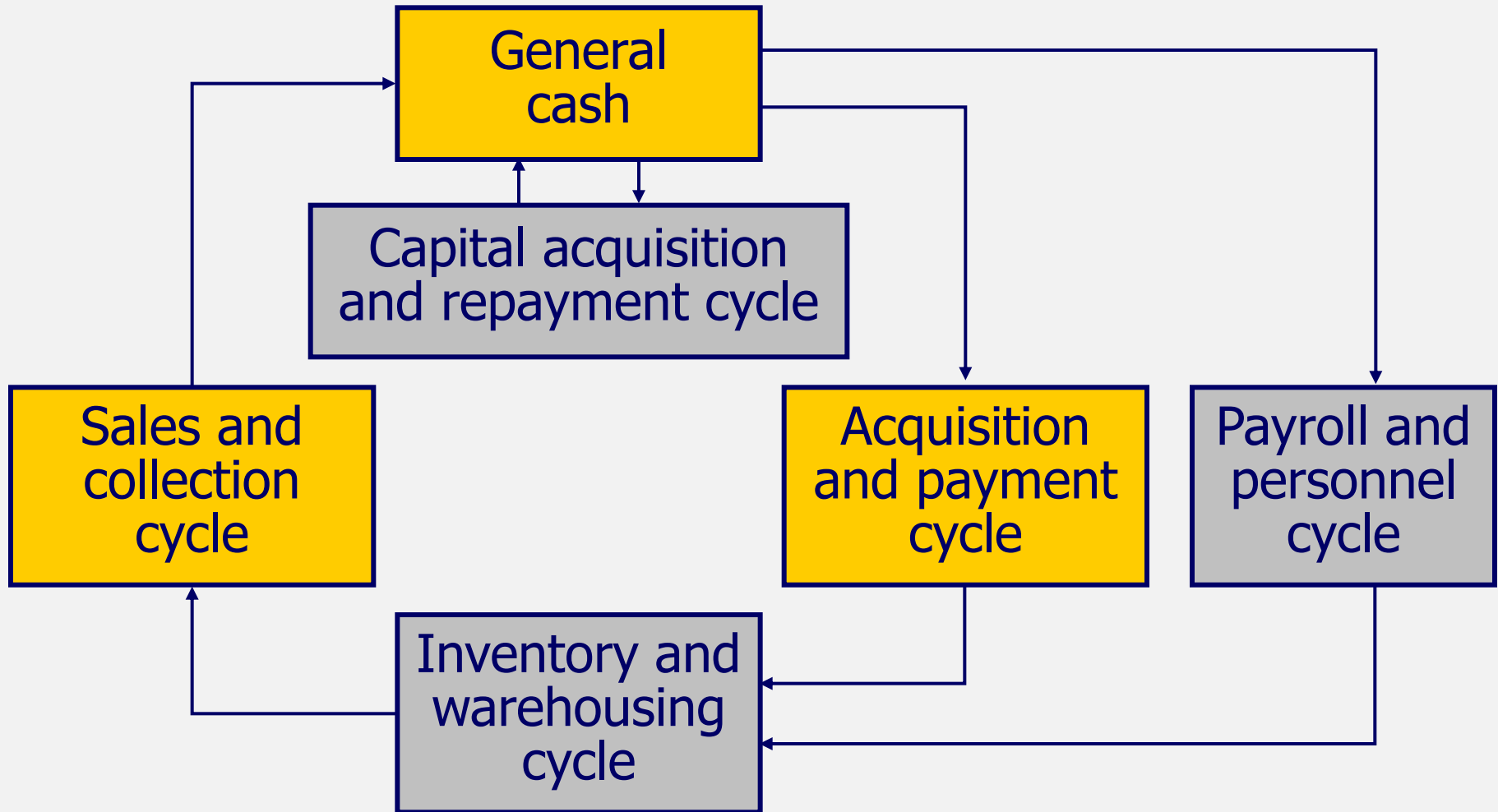
TABLE 6-1

## Cycles Applied to Hillsburg Hardware Co.

Cycle	Journals Included in the Cycle (See Figure 6-3, p. 169)	General Ledger Accounts Included in the Cycle (See Figure 6-4)	
		Balance Sheet	Income Statement
Sales and collection	Sales journal Cash receipts journal General journal	Cash in bank Trade accounts receivable Other accounts receivable Allowance for uncollectible accounts	Sales Sales returns and allowances Bad debt expense
Acquisition and payment	Acquisitions journal Cash disbursements journal General journal	Cash in bank Inventories Prepaid expenses Land Buildings Computer and other equipment Furniture and fixtures Accumulated depreciation Trade accounts payable Other accrued payables Accrued income tax Deferred tax	Advertising <sup>S</sup> Travel and entertainment <sup>S</sup> Sales meetings and training <sup>S</sup> Sales and promotional expense <sup>S</sup> Miscellaneous sales expense <sup>S</sup> Travel and entertainment <sup>A</sup> Stationery and supplies <sup>A</sup> Postage <sup>A</sup> Telecommunications <sup>A</sup> Computer maintenance and supplies <sup>A</sup> Depreciation <sup>A</sup> Rent <sup>A</sup> Legal fees and retainers <sup>A</sup> Auditing and related services <sup>A</sup> Insurance <sup>A</sup> Office repairs and maintenance expense <sup>A</sup> Miscellaneous office expense <sup>A</sup> Miscellaneous general expense <sup>A</sup> Gain on sale of assets Income taxes
Payroll and personnel	Payroll journal General journal	Cash in bank Accrued payroll Accrued payroll taxes	Salaries and commissions <sup>S</sup> Sales payroll taxes <sup>S</sup> Executive and office salaries <sup>A</sup> Administrative payroll taxes <sup>A</sup>
Inventory and warehousing	Acquisitions journal Sales journal General journal	Inventories	Cost of goods sold
Capital acquisition and repayment	Acquisitions journal Cash disbursements journal General journal	Cash in bank Notes payable Long-term notes payable Accrued interest Capital stock Capital in excess of par value Retained earnings Dividends Dividends payable	Interest expense

S = Selling expense; A = general and administrative expense.

# Relationships Among Transaction Cycles





Distinguish among the three categories of management assertions about financial information.



# Management Assertions

1. Assertions about classes of transactions and events for the period under audit
2. Assertions about account balances at period end
3. Assertions about presentation and disclosure

# Management Assertions for Each Category of Assertions

Transactions and Events	Account Balances	Presentation and Disclosure
Occurrence	Existence	Occurrence and rights and obligations
Completeness	Completeness	Completeness
Accuracy	Valuation and allocation	Accuracy and valuation
Classification		Classification and understandability
Cutoff		
	Rights and obligations	

# Management Assertions for

**TABLE 6-2**

**Management Assertions for Each Category of Assertions**

Assertions About Classes of Transactions and Events	Assertions About Account Balances	Assertions About Presentation and Disclosure
<i>Occurrence</i> – Transactions and events that have been recorded have occurred and pertain to the entity.	<i>Existence</i> – Assets, liabilities, and equity interests exist.	<i>Occurrence and rights and obligations</i> – Disclosed events and transactions have occurred and pertain to the entity.
<i>Completeness</i> – All transactions and events that should have been recorded have been recorded.	<i>Completeness</i> – All assets, liabilities, and equity interests that should have been recorded have been recorded.	<i>Completeness</i> – All disclosures that should have been included in the financial statements have been included.
<i>Accuracy</i> – Amounts and other data relating to recorded transactions and events have been recorded appropriately.	<i>Valuation and allocation</i> – Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation adjustments are appropriately recorded.	<i>Accuracy and valuation</i> – Financial and other information are disclosed appropriately and at appropriate amounts.
<i>Classification</i> – Transactions and events have been recorded in the proper accounts.		<i>Classification and understandability</i> – Financial and other information is appropriately presented and described and disclosures are clearly expressed.
<i>Cutoff</i> – Transactions and events have been recorded in the correct accounting period.		
	<i>Rights and obligations</i> – The entity holds or controls the rights to assets, and liabilities are the obligation of the entity.	

# PCAOB Assertions

Existence or Occurrence

Completeness

Valuation or  
allocation

Rights and obligations

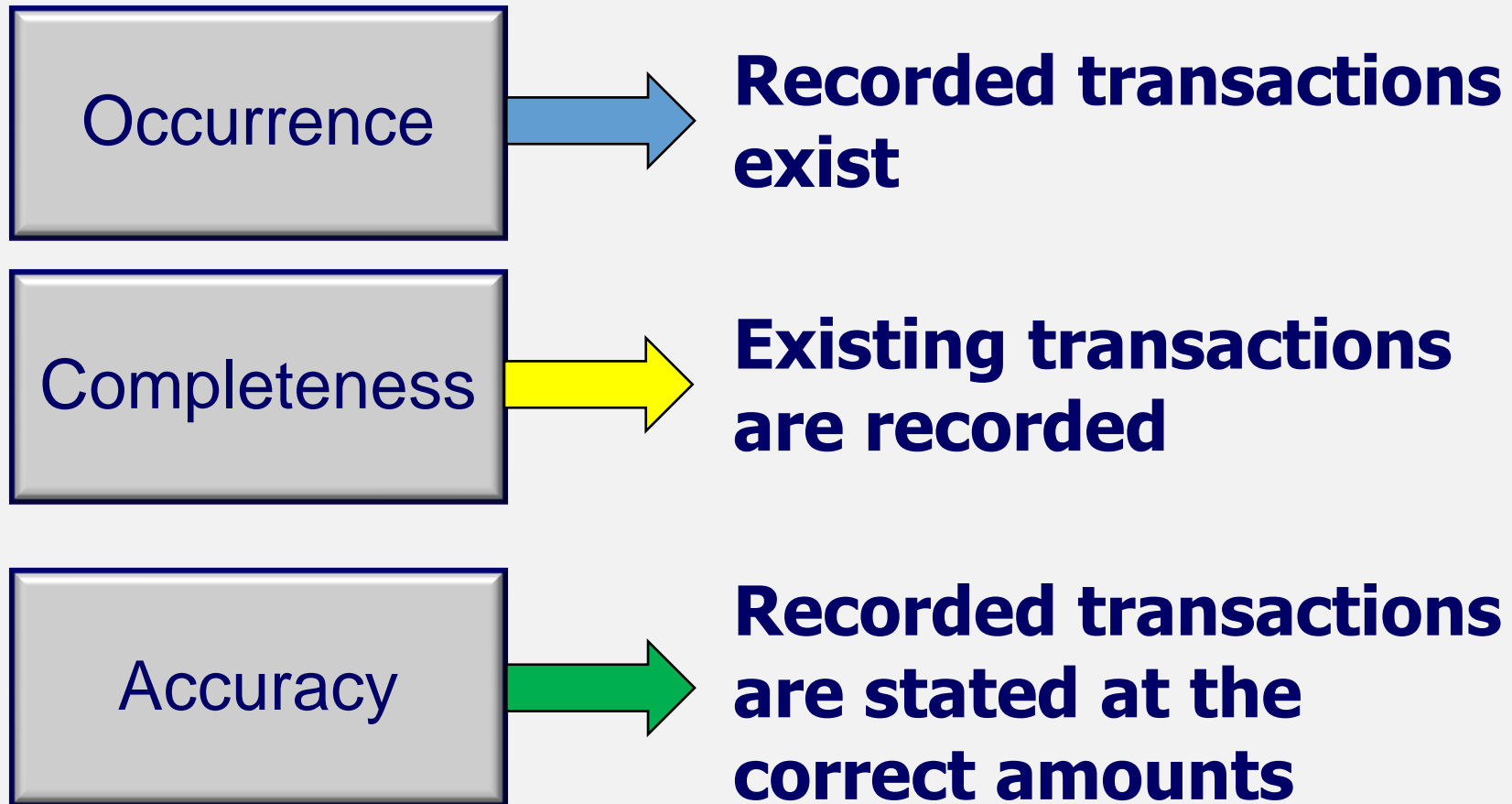
Presentation and  
disclosure

Similar to AICPA auditing standards as the first three assertions are applicable to balances and transactions. Presentation is treated as a single assertion.

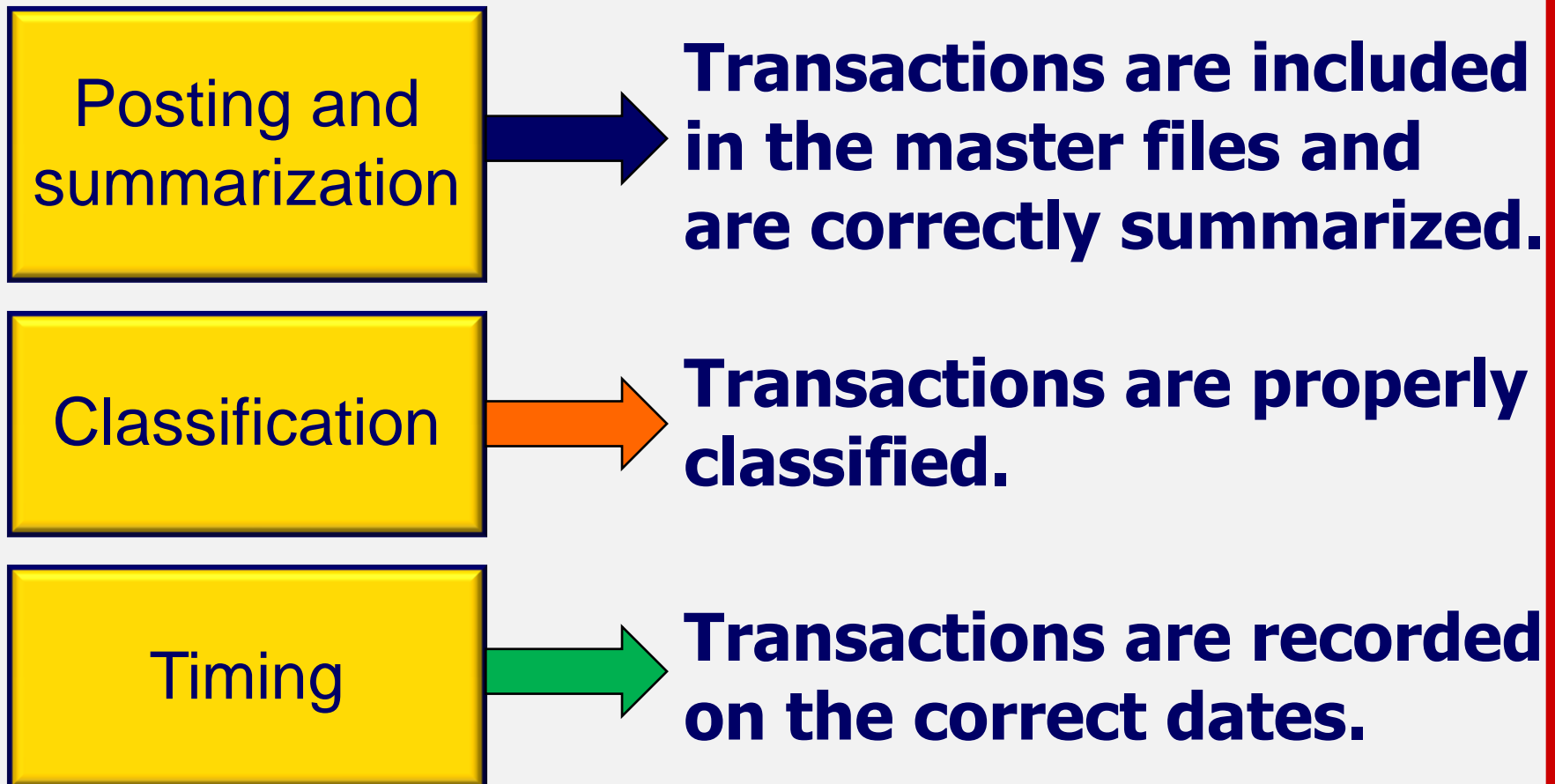


Link the six general transaction-related audit objectives to management assertions for classes of transactions.

# General Transaction-related Audit Objectives



# General Transaction-related Audit Objectives



# Hillsburg Hardware Co.

## (Applied to Sales Transactions)

**TABLE 6-3**

### **Hillsburg Hardware Co.: Management Assertions and Transaction-Related Audit Objectives Applied to Sales Transactions**

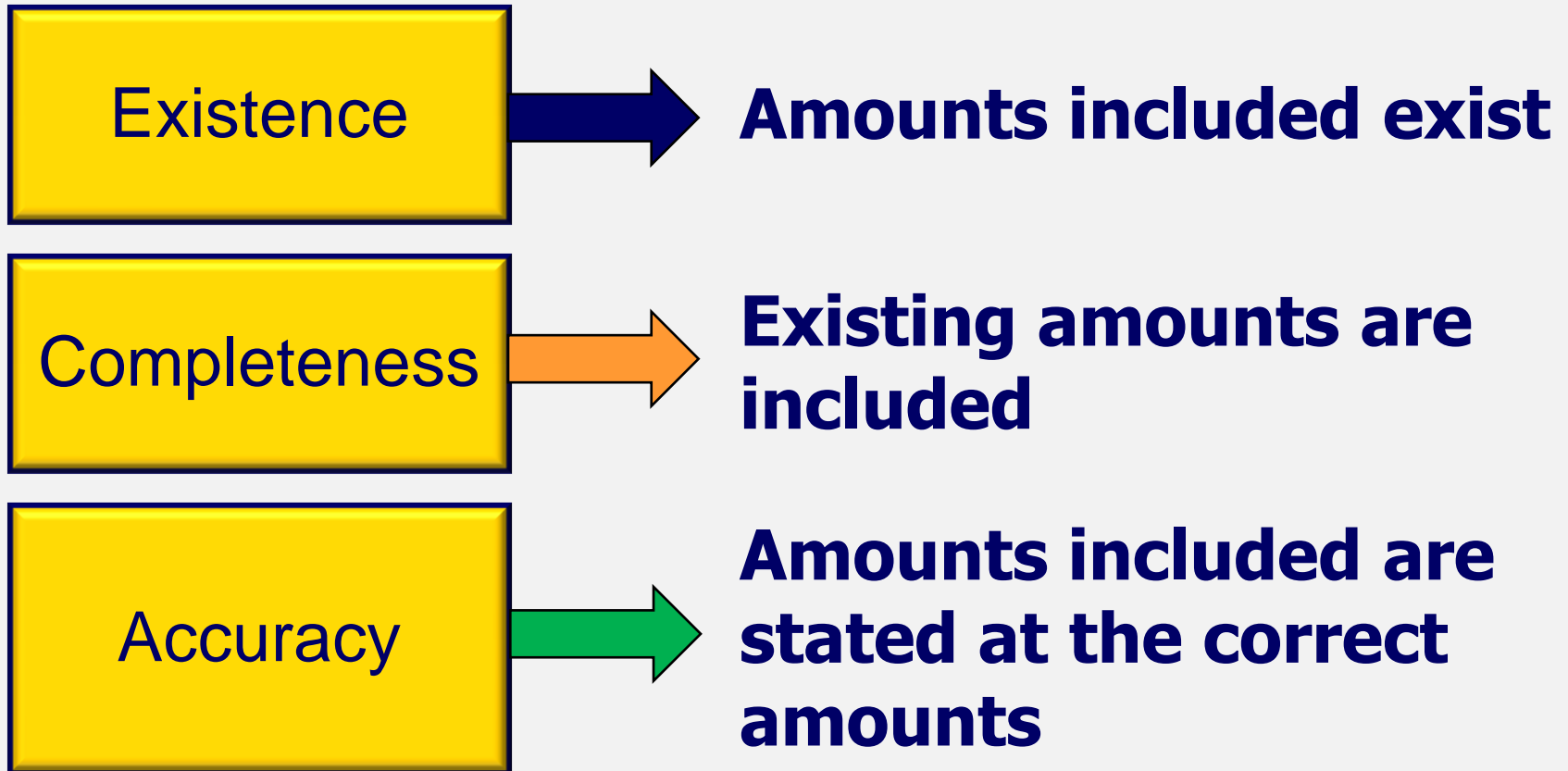
<b>Management Assertions About Classes of Transactions and Events</b>	<b>General Transaction-Related Audit Objectives</b>	<b>Specific Sales Transaction-Related Audit Objectives</b>
Occurrence	Occurrence	Recorded sales are for shipments made to nonfictitious customers.
Completeness	Completeness	Existing sales transactions are recorded.
Accuracy	Accuracy	Recorded sales are for the amount of goods shipped and are correctly billed and recorded.
	Posting and summarization	Sales transactions are properly included in the master file and are correctly summarized.
Classification	Classification	Sales transactions are properly classified.
Cutoff	Timing	Sales transactions are recorded on the correct dates.





Link the eight general balance-related audit objectives to management assertions for account balances.

# General Balance-related Audit Objectives



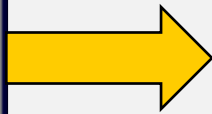
# General Balance-related Audit Objectives

Classification



**Amounts are properly classified**

Cutoff



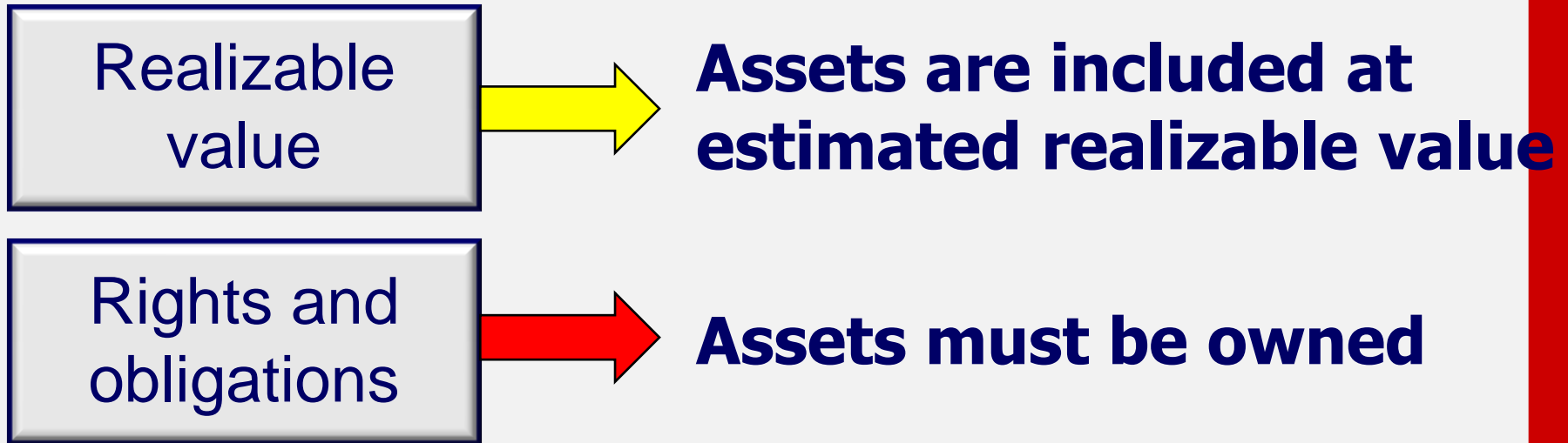
**Transactions are recorded in the proper period**

Detail tie-in



**Account balances agree with master file amounts, and with the general ledger**

# General Balance-related Audit Objectives



# Hillsburg Hardware Co.

## (Applied to Inventory)

**TABLE 6-4**

### **Hillsburg Hardware Co.: Management Assertions and Balance-Related Audit Objectives Applied to Inventory**

<b>Management Assertions About Account Balances</b>	<b>General Balance-Related Audit Objectives</b>	<b>Specific Balance-Related Audit Objectives Applied to Inventory</b>
Existence	Existence	All recorded inventory exists at the balance sheet date.
Completeness	Completeness	All existing inventory has been counted and included in the inventory summary.
Valuation and allocation	Accuracy	Inventory quantities on the client's perpetual records agree with items physically on hand. Prices used to value inventories are materially correct. Extensions of price times quantity are correct and details are correctly added.
	Classification	Inventory items are properly classified as to raw materials, work in process, and finished goods.
	Cutoff	Purchase cutoff at year-end is proper. Sales cutoff at year-end is proper.
	Detail tie-in Realizable value	Total of inventory items agrees with general ledger. Inventories have been written down where net realizable value is impaired.
Rights and obligations	Rights and obligations	The company has title to all inventory items listed. Inventories are not pledged as collateral.

# 9

Link the four presentation- and disclosure-related audit objectives to management assertions for presentation and disclosure.

# Hillsburg Hardware Co.

## (Applied to Notes Payable)

**TABLE 6-5**

### **Hillsburg Hardware Co.: Management Assertions and Presentation and Disclosure-Related Audit Objectives Applied to Notes Payable**

Management Assertions About Presentation and Disclosure	General Presentation- and Disclosure-Related Audit Objectives	Specific Presentation and Disclosure-Related Audit Objectives Applied to Notes Payable
Occurrence and rights and obligations	Occurrence and rights and obligations	Notes payable as described in the footnotes exist and are obligations of the company.
Completeness	Completeness	All required disclosures related to notes payable are included in the financial statement footnotes.
Accuracy and valuation	Accuracy and valuation	Footnote disclosures related to notes payable are accurate.
Classification and understandability	Classification and understandability	Notes payable are appropriately classified as to short-term and long-term obligations and related financial statement disclosures are understandable.

# 10

Explain the relationship between audit objectives and the accumulation of audit evidence.



# How Audit Objectives Are Met

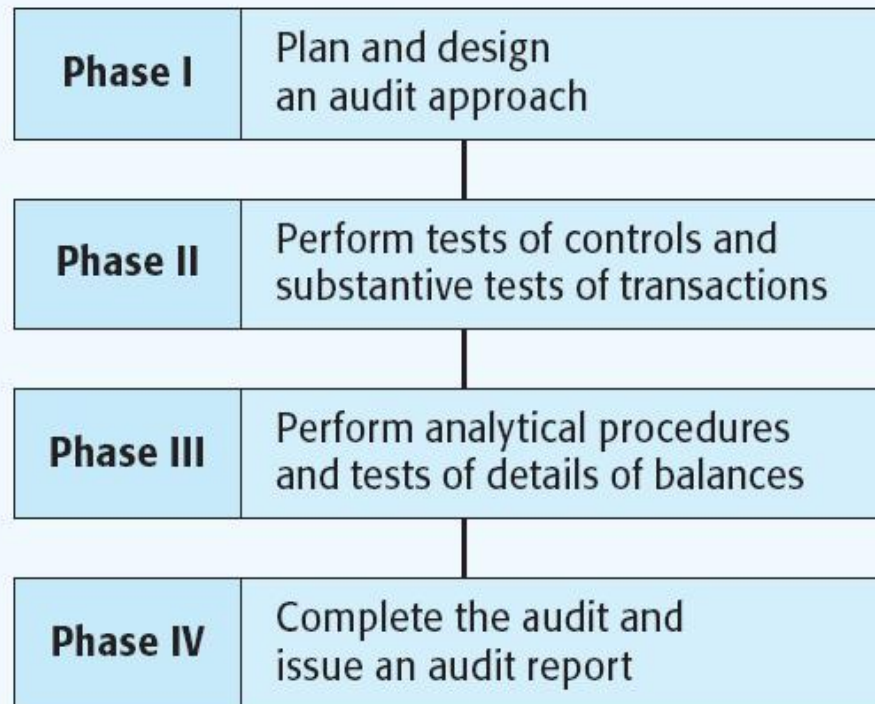
The auditor must obtain sufficient appropriate audit evidence to support all management assertions in the financial statements.

- An audit process has four specific phases

# Four Phases of a Financial Statement Audit

**FIGURE 6-7**

**Four Phases of a Financial Statement Audit**



# End of Chapter 6

