Ch. 6 & 7 Textbook Exercises

Name

Comprehensive Question 6-26

(Audit programs and assertions) Assume that you are responsible for developing an audit program for a manufacturing client that sells to over 1,400 customers. You want to ensure your audit program addresses all relevant assertions for sales and accounts receivable. Address the following question in the context of the audit sales and receivables for this manufacturing client.

Required

A. What is the purpose of an audit program?

An audit program "documents decision about the audit procedures that the auditor believes are necessary to obtain reasonable assurance that the financial statements are presented fairly in all material respects" (Boynton & Johnson, 2006, p. 251). The audit program is required and is part of generally accepted auditing standards. The audit program includes procedures to be performed, who performed them, and when. The program also includes a cross-reference to working papers. The working papers are a way for the auditor to document both their work and any evidence collected. " Generally accepted auditing standards describe working papers as records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusion reached in the audit" (Boynton & Johnson, 2006, p. 254). For example, evidence obtained when auditing accounts receivable might include prior year work papers to trace beginning balances to or a sampling of sales invoice to vouch debits to.

B. Explain why auditors translate audit assertions into specific audit objectives when developing an audit program.

Assertions are used to "make decisions about the assessment of risk by considering the types of potential misstatements that may occur, and design audit procedures that are appropriate to the assertion and to the risk assessment" (Boynton & Johnson, 2006, p. 187). The assertions, or audit objectives, provide a framework for auditors to follow during the audit program. That framework allows the auditor "to identify the relevant transactions, account balances, and disclosures in the financial statements for a transaction cycle that is being audited" (Boynton & Johnson, 2006, p. 231). For example, when auditing the revenue cycle, the auditor could establish

transaction objectives such as occurrence, completeness, accuracy, cutoff, and classification. When auditing account balances, the auditor might establish objectives such as existence, completeness, rights and obligations, and valuation and allocation. Finally, when auditing disclosures, the auditor may establish objectives such as occurrence, completeness, and classification. All these objectives are actually assertions outlined in GAAP.

C. If you are auditing the existence and occurrence assertion, what specific audit objectives should be accomplished by developing an audit program? Explain the purpose of each audit objective.

Specific audit objectives that should be accomplished in auditing the existence and occurrence assertion when developing an audit program includes the following:
Transaction Audit Objective- Occurrence: All sales, receivables, and cash receipts have been recorded during the period the transaction occurred in and revenue is recognized correctly. Transaction Audit Objective- Cutoff: All sales, receivables, and cash receipts have been recorded in the correct period and sales revenue has not been recognized that should be in a subsequent period.
Balance Audit Objective- Existence: All accounts receivables are valid amounts and do actually exist.

D. If you are auditing the valuation or allocation assertion, what specific audit objectives should be accomplished by developing an audit program? Explain the purpose of each audit objective.

Specific audit objectives that should be accomplished in auditing the valuation or allocation assertion when developing an audit program include the following:
Transaction Audit Objective- Accuracy: All sales, receivables, and cash receipts have been accurately recorded with the correct amount.
Balance Sheet Objective- Valuation and Allocation: Accounts receivable are recorded at the net realizable value and appropriate allowance for doubtful accounts is recorded properly.

Case 7-25 (Part b)

(New Client Acceptance) Comprehensive Case: Mt. Hood Furniture, Inc.

Company Background Information: Your employer, Reddy & Abel, LLP, Certified Public Accountants (who is registered with the PCAOB and audits public companies), has been approached by a prospective client, Mt. Hood Furniture, Inc., about your firm taking on their account. The firm has adopted procedures for the acceptance and retention of clients following the AICPA guidelines for quality control in an accounting practice. The firm requires that a partner interview all prospective clients to determine what services the client needs and the ability of the firm to provide those services. As the prospective senior on the engagement, you accompanied the partner on the interview. The following is a summary of your notes from the interviews with senior management.

Notes from Client Interview: Mt. Hood Furniture, Inc. is an Oregon corporation incorporated in 1961. The company is a regional manufacturer of office furniture and cabinetry. The product line includes desks, chairs, filing cabinets, bookcases, credenzas, and European-style cabinets. Approximately 80 percent of fiscal year 20X3 net sales were in office furniture and 20 percent in cabinetry. The cabinetry unit underwent major retooling commencing in 20X2, which approximated 85 percent of the capital expenditures that year. The retooling was financed with significant long-term debt. The improvements enabled the company to manufacture ready-to-assemble furniture products, and develop a modular ready-to-install cabinet line, which has resulted in an increase in sales. The company has developed new, award-winning designs in office furniture, designs that stress the efficient and ergonomic use of technology. Many opportunities exist to expand sales of the existing product lines. Management estimates that the current physical plant can support up to $50 million in sales without significant additions of manufacturing and distribution capacity. Additional sales up to $50 million are expected to result in additional costs associated with the variable cost of production and variable overheads but should not require increases in fixed costs.

Office furniture is a highly competitive, multibillion-dollar annual market. With a strong economy the market has grown about 15 percent per year over the last two years; however, industry experts expect this growth to slow down in the years ahead. Mt. Hood does not have significant market share and competes with a number of nationally recognized companies. Mt. Hood's primary advantages are competitive pricing and consistently high-quality products. Its low-profit margins are part of a pricing strategy to build market share by undercutting the competition. The custom office cabinetry grants the company a wider profit margin and substantial sales growth potential. This is a unique product line; it offers a custom-built look that is not readily available from other