A424: Chapter 6
Audit Responsibilities and Objectives

I. Introduction
- Review Chapters 1 through 5: Auditing foundations

**Preparation questions:**

1. What is the ultimate goal of the audit of the financial statements?

2. What conditions may affect reaching the outcome/achievement of the goal?

- Responsibilities bound by Code of Conduct, GAAS, and fear of litigation.
- Chapters 6 through 13: Framework for developing audit plan (Phase I below)

**Preparation Question:** The phases of an audit are reflected in the ten board guidelines known as GAAS. Recognizing that there will be some overlap, indicate the pertinent GAAS standard(s) next to each of related phase(s) in the illustration above.

**Preparation Question:** If we are not able to execute our audit as planned this potentially may result in what type of reporting condition (from Chapter 3)?
II. Auditor’s objective

- Express an opinion on the financial statements.

- Two approaches to planning an audit:
  1. Accounting Process (i.e., recording of transactions which make-up ending balances – transaction approach with emphasis on internal controls)
  2. Accounting Balances (focus on verification of ending balances – balance sheet approach, if the balance sheet is fairly stated so is net income)

III. Management’s responsibility

- Prepare financial statements by making assertions.
  - SAS 106 (AU 326) classifies the assertions into the following categories:
    1. Classes of transactions and events for the period (Occurrence, completeness, accuracy, classification, and cutoff)
    2. Account balances at period end (Existence, completeness, valuation and allocation and rights and obligations)
    3. Presentation and disclosure (occurrence and rights and obligations, completeness, accuracy and valuation, and classification and understandability)

- Report of Management – States management’s responsibilities for the financial statements. See Figure 6-2 (p. 143)

- Sarbanes-Oxley (SOX) – CEO and CFO certify financial statements submitted to SEC. Fines and imprisonment for knowingly filing false information.

IV. Auditor’s responsibilities

A. Provide reasonable assurance that material misstatements do not exist.

Preparation Question: Auditing standards define “reasonable” as a __________, but not __________ level of assurance.
Preparation Question: Why not provided absolute assurance?
1.
2.
3.

B. Report and communicate findings
- Attitude of professional skepticism – cautious but not accusatory
- Reasonable assurance – High but not absolute level of certainty.
- Misstatements
  1. errors
  2. fraud

Preparation question: List the two types of fraud.

Preparation Question:
Three equally material errors or frauds follow:
1. Unintentional use of inventory method not in accordance with GAAP.
2. Employee does not record cash sales in cash register and keeps the cash.
3. Management withholds information from auditor about a lawsuit for a patent infringement and does not include it as a footnote.

Required:
1. Which are errors and which are frauds?
2. Should auditors have equal responsibilities for discovering each one?
3. Which is usually more difficult to detect?

Preparation Question: Discovery of errors and/or frauds would be what type of reporting condition (from Chapter 3)?

- Assessing Risks of Fraud
  1. Fraudulent financial reporting
     a) Management's characteristics and influence over the control environment.
     b) Industry conditions.
     c) Operating characteristics and financial stability.
  2. Misappropriation of assets
     a) Susceptibility of assets to misappropriation.
     b) Internal and other types of controls.
- Illegal acts
  1. Direct effect
     a. affects account balances.
     b. same responsibility to search for as with errors or fraud.
  2. Indirect effect
     a. potential (contingent) liability. Disclosure required.
     b. auditor provides no assurance on detection.
3. Responsibility
   a. Unlikely - discovery through normal procedures
   b. Possible - search and consult
   c. Known – report, relationship, responsibility

**Toss-up Question:** What broad GAAP concepts especially concern auditors? That is, where are the riskiest areas for misstatements in the financial statements?

V. **Financial statement cycles**
   A. Grouping related accounts together in order to more efficiently audit them.
   B. Groups
      1. Sales and collection
      2. Acquisition and payment
      3. Payroll and personnel
      4. Inventory and warehousing
      5. Capital acquisition and repayment
   C. Refer to Figure 6-3 (p. 148) and Table 6-1 (p. 151)
VI. Setting audit objectives

- Goal to obtain sufficient competent evidential matter to support management's assertions (GAAS Fieldwork #3).
- Phases of an audit (refer to Figure 6-7).
- Steps to develop audit objectives (refer to Figure 6-1).

A. Management assertions: “criteria that management uses to record and disclose accounting information in financial statements.”
   See Table 2, p. 154.

B. Transaction Related Audit Objectives (TRAOs) → used primarily for evaluating the existence and quality of internal controls.
   1. Occurrence (transaction did occur)
   2. Completeness (all existing transactions recorded)
   3. Accuracy (transaction is for correct amount)
   4. Posting and summarizing (transactions accumulated and transferred)
   5. Classification (proper categorization – right account)
   6. Timing (dates)

C. Balance Related Audit Objectives (BRAOs) → used primarily for evaluating amounts and information reported in the financial statements especially balance sheet amounts.
   1. Existence (all items reflected in f/s do exist)
   2. Completeness (all existing items reflected in f/s)
   3. Accuracy (balance is for correct amount)
   4. Classification (proper categorization – right account & properly reflected on f/s)
   5. Cut-off (dates)
   6. Detail tie-in (supporting document that describes what an ending account balance is comprised of as of a particular date)
   7. Realizable value (reasonable valuation of account balance)
   8. Rights and obligations (assets and liabilities)

D. Presentation and disclosure (as required per GAAP)
   1. Occurrence and rights and obligations
   2. Completeness
   3. Accuracy and Valuation
   4. Classification and understandability

Note: TRAOs and BRAOs are both used in every audit, one set of objectives does not replace the other. The emphasis on each set varies depending on the situation. If objectives satisfied, should be able to express an opinion.

E. Relationship between management assertion and audit objectives.
**Preparation Question:** In the table below, match the list of transaction related audit objectives (TRAOs) and balance related audit objectives (BRAOs) with the appropriate management assertion.

<table>
<thead>
<tr>
<th>Management Assertions</th>
<th>TRAOs</th>
<th>Management Assertions</th>
<th>BRAOs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence</td>
<td></td>
<td>Existence</td>
<td></td>
</tr>
<tr>
<td>Completeness</td>
<td></td>
<td>Completeness</td>
<td></td>
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<tr>
<td>Accuracy</td>
<td></td>
<td>Valuation and Allocation</td>
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<tr>
<td></td>
<td></td>
<td>Rights and obligations</td>
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<tr>
<td>Classification</td>
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<tr>
<td>Cutoff</td>
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</tbody>
</table>

What is the relationship between Management’s assertions about Presentation and Disclosures and the Auditor’s Objectives?
In-class example:
The audit procedures below belong to which of the financial statement cycles? ________________________________________

<table>
<thead>
<tr>
<th>Specific Objectives</th>
<th>TRAO</th>
<th>BRAO</th>
<th>General Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recorded cash disbursement transactions are for the amount of goods or services received and are correctly recorded.</td>
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<tr>
<td>Cash disbursement transactions are properly included in the accounts payable master file and are correctly summarized.</td>
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<tr>
<td>Recorded cash disbursements are for goods and services actually received.</td>
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<tr>
<td>Cash disbursement transactions are properly classified.</td>
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<tr>
<td>Existing cash disbursement transactions are recorded.</td>
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<tr>
<td>Cash disbursement transactions are recorded on the correct dates.</td>
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<tr>
<td>There are no unrecorded fixed assets in use.</td>
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<tr>
<td>The company has a valid title to the assets owned.</td>
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<td>Details of property, plant, and equipment agree with the general ledger.</td>
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<td>Fixed assets physically exist and are being used for the purpose intended.</td>
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<td>Property, plant, and equipment are recorded at the correct amount.</td>
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<td>The company has a contractual right for use of assets leased.</td>
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<td>Cash disbursements and/or accrual cutoff for property, plant, and equipment items are proper.</td>
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<td>Expense accounts do not contain amounts that should have been capitalized.</td>
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<td>Depreciation is determined in accordance with an acceptable method and is materially correct as computed.</td>
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<td>Fixed asset accounts have been properly adjusted for declines in historical cost.</td>
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<tr>
<td>Liens or other encumbrances on property, plant, and equipment items are known and disclosed.</td>
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<tr>
<td>All required disclosures regarding fixed assets have been made.</td>
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<tr>
<td>Footnote disclosures related to fixed assets are clear and understandable.</td>
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<tr>
<td>Methods and useful lives disclosed for each category of fixed asset are accurate.</td>
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<tr>
<td>Disclosed fixed asset dispositions have occurred.</td>
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</tbody>
</table>
VII. Satisfy Audit Objectives through Knowledge, Test Results, and Assessment.
   A. Obtain an Understanding of the Entity and Its Environment
   B. Understand Internal Controls and Assess Control Risk
   C. Assess Risk of Material Misstatement
   D. Tests of Control
   E. Substantive Tests of Transactions
   F. Analytical Procedures
   G. Tests of Details of Balances

**Preparation Questions:**
1. Which of the above (D through G) tests, are associated with the TRAOs?
2. Which of the above tests are associated with the BRAOs?
3. Which of the above activities (A to G) are completed during Phase I?
4. Which of the above activities are completed during Phase II?
5. Which of the above activities are completed during Phase III?
6. Which of the above activities are completed during Phase IV?

**Summary:**