

Multiple-Choice Questions (1–54)

A. Overview of the Attest Function

- Generally accepted auditing standards are
 - Required procedures to be used to gather evidence to support financial statements.
 - Policies and procedures designed to provide reasonable assurance that the CPA firm and its personnel comply with professional standards.
 - Pronouncements issued by the Auditing Standards Board.**
 - Rules acknowledged by the accounting profession because of their universal application.
- Which of the following is a conceptual difference between the attestation standards and generally accepted auditing standards?
 - The attestation standards do not apply to audits of historical financial statements, while the generally accepted auditing standards do.**
 - The requirement that the practitioner be independent in mental attitude is omitted from the attestation standards.
 - The attestation standards do not permit an attest engagement to be part of a business acquisition study or a feasibility study.
 - The attestation standards include reviews, while generally accepted auditing standards do not.
- Which of the following is **not** an attestation standard?
 - Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.
 - The report shall identify the subject matter on the assertion being reported on and state the character of the engagement.
 - The work shall be adequately planned and assistants, if any, shall be properly supervised.
 - A sufficient understanding of internal control shall be obtained to plan the engagement.**
- Which of the following is **most** likely to be unique to the audit work of CPAs as compared to work performed by practitioners of other professions?
 - Due professional care.
 - Competence.
 - Independence.**
 - Complex body of knowledge.
- The Public Company Accounting Oversight Board's standards require that due care is to be exercised in the performance of an audit. This standard is ordinarily interpreted to require
 - Thorough review of the existing safeguards over access to assets and records.
 - Limited review of the indications of employee fraud and illegal acts.
 - Objective review of the adequacy of the technical training and proficiency of firm personnel.
 - Critical review of the judgment exercised at every level of supervision.**

B. AICPA Code of Professional Conduct

- For which of the following can a member of the AICPA receive an automatic expulsion from the AICPA?
 - Member is convicted of a crime punishable by imprisonment for more than one year..
 - Member files his own fraudulent tax return.
 - Member files fraudulent tax return for a client knowing that it is fraudulent.
 - I only.
 - I and II only.
 - I and III only.
 - I, II, and III.**
- Which of the following is an example of a safeguard implemented by the client that might mitigate a threat to independence?
 - Required continuing education for all attest engagement team members.
 - An effective corporate governance structure.**
 - Required second partner review of an attest engagement.
 - Management selection of the CPA firm.
- Which of the following is a "self review" threat to member independence?
 - An engagement team member has a spouse that serves as CFO of the attest client.
 - A second partner review is required on all attest engagements.
 - An engagement team member prepares invoices for the attest client.**
 - An engagement team member has a direct financial interest in the attest client.
- According to the standards of the profession, which of the following circumstances will prevent a CPA performing audit engagements from being independent?
 - Obtaining a collateralized automobile loan from a financial institution client.
 - Litigation with a client relating to billing for consulting services for which the amount is immaterial.
 - Employment of the CPA's spouse as a client's director of internal audit.**
 - Acting as an honorary trustee for a not-for-profit organization client.
- The profession's ethical standards **most** likely would be considered to have been violated when a CPA represents that specific consulting services will be performed for a stated fee and it is apparent at the time of the representation that the
 - Actual fee would be substantially higher.**
 - Actual fee would be substantially lower than the fees charged by other CPAs for comparable services.
 - CPA would **not** be independent.
 - Fee was a competitive bid.

11. According to the ethical standards of the profession, which of the following acts is generally prohibited?

- a. Issuing a modified report explaining a failure to follow a governmental regulatory agency's standards when conducting an attest service for a client.
- b. Revealing confidential client information during a quality review of a professional practice by a team from the state CPA society.
- c. Accepting a contingent fee for representing a client in an examination of the client's federal tax return by an IRS agent.
- d. Retaining client records after an engagement is terminated prior to completion and the client has demanded their return.

12. According to the profession's ethical standards, which of the following events may justify a departure from a Statement of the Governmental Accounting Standards Board?

	New legislation	Evolution of a new form of business transaction
a.	No	Yes
b.	Yes	No
c.	Yes	Yes
d.	No	No

13. May a CPA hire for the CPA's public accounting firm a non-CPA systems analyst who specializes in developing computer systems?

- a. Yes, provided the CPA is qualified to perform each of the specialist's tasks.
- b. Yes, provided the CPA is able to supervise the specialist and evaluate the specialist's end product.
- c. No, because non-CPA professionals are **not** permitted to be associated with CPA firms in public practice.
- d. No, because developing computer systems is **not** recognized as a service performed by public accountants.

14. During an audit Bill Adams believes that his supervisor's position on an accounting matter, although consistent with the client's desires, materially departs from GAAP—the basis followed for the client's financial statements. Bill discussed his concerns with his supervisor and the matter is still not resolved. Following the AICPA *Code of Professional Conduct*, which of the following is **least** likely to be appropriate?

- a. Bill should consider consulting with legal counsel.
- b. Bill should determine whether there are responsibilities to communicate the matter to third parties.
- c. Bill should document his understanding of the situation in the working papers.
- d. Bill should use the discreditable acts framework to determine whether his supervisor is involved in an act discreditable to the profession.

15. According to the standards of the profession, which of the following activities would most likely **not** impair a CPA's independence?

- a. Providing advisory services for a client.
- b. Contracting with a client to supervise the client's office personnel.
- c. Signing a client's checks in emergency situations.
- d. Accepting a luxurious gift from a client.

16. Which of the following reports may be issued only by an accountant who is independent of a client?

- a. Standard report on an examination of a financial forecast.
- b. Report on consulting services.
- c. Compilation report on historical financial statements.
- d. Compilation report on a financial projection.

17. According to the requirements of the public accounting profession, which of the following activities may be required in exercising due care?

	Consulting with experts	Obtaining specialty accreditation
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

18. Larry Sampson is a CPA and is serving as an expert witness in a trial concerning a corporation's financial statements. Which of the following is(are) true?

- I. Sampson's status as an expert witness is based upon his specialized knowledge, experience, and training.
 - II. Sampson is required by AICPA ruling to present his position objectively.
 - III. Sampson may regard himself as acting as an advocate.
- a. I only.
 - b. I and II only.
 - c. I and III only.
 - d. III only.

19. According to the ethical standards of the profession, which of the following acts is generally prohibited?

- a. Purchasing a product from a third party and reselling it to a client.
- b. Writing a financial management newsletter promoted and sold by a publishing company.
- c. Accepting a commission for recommending a product to an audit client.
- d. Accepting engagements obtained through the efforts of third parties.

20. To exercise due professional care an auditor should

- a. Critically review the judgment exercised by those assisting in the audit.
- b. Examine all available corroborating evidence supporting managements assertions.
- c. Design the audit to detect all instances of illegal acts.
- d. Attain the proper balance of professional experience and formal education.

21. Kar, CPA, is a staff auditor participating in the audit engagement of Fort, Inc. Which of the following circumstances impairs Kar's independence?

- a. During the period of the professional engagement, Fort gives Kar tickets to a football game worth \$75.
- b. Kar owns stock in a corporation that Fort's 401(k) plan also invests in.
- c. Kar's friend, an employee of another local accounting firm, prepares Fort's tax returns.
- d. Kar's sibling is director of internal audit at Fort.

22. On June 1, 20X8, a CPA obtained a \$100,000 personal loan from a financial institution client for whom the CPA provided compilation services. The loan was fully secured and considered material to the CPA's net worth. The CPA paid the loan in full on December 31, 20X9. On April 3, 20X9, the client asked the CPA to audit the client's financial statements for the year ended December 31, 20X9. Is the CPA considered independent with respect to the audit of the client's December 31, 20X9 financial statements?

- a. Yes, because the loan was fully secured.
- b. Yes, because the CPA was not required to be independent at the time the loan was granted.
- c. No, because the CPA had a loan with the client during the period of a professional engagement.
- d. No, because the CPA had a loan with the client during the period covered by the financial statements.

23. Which of the following statements is(are) correct regarding a CPA employee of a CPA firm taking copies of information contained in client files when the CPA leaves the firm?

- I. A CPA leaving a firm may take copies of information contained in client files to assist another firm in serving that client.
- II. A CPA leaving a firm may take copies of information contained in client files as a method of gaining technical expertise.

- a. I only.
- b. II only.
- c. Both I and II.
- d. Neither I nor II.

24. Which of the following statements is correct regarding an accountant's working papers?

- a. The accountant owns the working papers and generally may disclose them as the accountant sees fit.
- b. The client owns the working papers but the accountant has custody of them until the accountant's bill is paid in full.
- c. The accountant owns the working papers but generally may not disclose them without the client's consent or a court order.
- d. The client owns the working papers but, in the absence of the accountant's consent, may not disclose them without a court order.

25. Which of the following is an authoritative body designated to promulgate attestation standards?

- a. Auditing Standards Board.
- b. Governmental Accounting Standards Board.

- c. Financial Accounting Standards Board.
- d. General Accounting Office.

26. The auditor with final responsibility for an engagement and one of the assistants have a difference of opinion about the results of an auditing procedure. If the assistant believes it is necessary to be disassociated from the matter's resolution, the CPA firm's procedures should enable the assistant to

- a. Refer the disagreement to the AICPA's Quality Review Committee.
- b. Document that member's disagreement with the conclusions reached after appropriate consultation.
- c. Discuss the disagreement with the entity's management or its audit committee.
- d. Report the disagreement to an impartial peer review monitoring team.

C. Quality Control

27. The nature and extent of a CPA firm's quality control policies and procedures depend on

	The CPA firm's size	The nature of the CPA firm's practice	Cost-benefit considerations
a.	Yes	Yes	Yes
b.	Yes	Yes	No
c.	Yes	No	Yes
d.	No	Yes	Yes

28. A CPA firm may communicate its quality control policies and procedures to its personnel in which manner(s):

	Orally	Written
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

29. Which of the following is **not** an element of quality control?

- a. Acceptance and continuance of client relationships and specific engagements.
- b. Human resources.
- c. Internal control.
- d. Monitoring.

30. Quality control for a CPA firm, as referred to in Statements on Quality Control Standards, applies to

- a. Auditing services only.
- b. Auditing and management advisory services.
- c. Auditing and tax services.
- d. Auditing and accounting and review services.

31. One of a CPA firm's basic objectives is to provide professional services that conform with professional standards. Reasonable assurance of achieving this basic objective is provided through

- a. A system of quality control.
- b. A system of peer review.
- c. Continuing professional education.
- d. Compliance with generally accepted accounting principles.

32. Which of the following is correct concerning PCAOB guidance that uses the term "should"?

- a. The auditor must fulfill the responsibilities.
- b. The auditor must comply with requirements unless s/he demonstrates that alternative actions were sufficient to achieve the objectives of the standard.
- c. The auditor should consider performing the procedure; whether the auditor performs depends on the exercise of professional judgment in the circumstances.
- d. The auditor has complete discretion as to whether to perform the procedure.

D. The Sarbanes-Oxley Act of 2002

33. Under the Sarbanes-Oxley Act, most audit working papers must be saved

- a. 5 years.
- b. 7 years.
- c. 10 years.
- d. Indefinitely as there is no time limitation provided.

34. Passage of the Sarbanes-Oxley Act led to the establishment of the

- a. Auditing Standards Board.
- b. Accounting Enforcement Releases Board.
- c. Public Company Accounting Oversight Board.
- d. Securities and Exchange Commission.

35. Under Title II of the Sarbanes-Oxley Act, the auditor of an issuer **cannot** legally perform which type of service for that issuer?

- a. Tax services.
- b. Review of interim information.
- c. Internal audit outsourcing services.
- d. Audit of internal control over financial reporting.

36. The audit partner in charge of an audit of a public company may only

- a. Be in charge of the audit of that one company.
- b. Perform the role as long as he or she also performs the "second partner review" for that audit.
- c. Perform that role for five consecutive years.
- d. Perform the role if he or she has proper AICPA issuer accreditation.

E. Public Company Accounting Oversight Board

37. Which of the following is correct concerning membership on the Public Company Accounting Oversight Board?

- a. Only two of its members may be CPAs.
- b. It is composed of nine members.

- c. All members must also currently be active in public accounting.
- d. A majority of members must be or have been accounting educators.

38. The Public Company Accounting Oversight Board (PCAOB) is **not** responsible for standards related to

- a. Accounting.
- b. Attestation.
- c. Auditing.
- d. Quality control.

39. A PCAOB engagement that focuses on the sufficiency of a CPA firm's quality control system is **most** likely to be referred to as a(n)

- a. Financial statement audit.
- b. Inspection.
- c. Peer review.
- d. Quality control

40. Which statement below is correct concerning communicating the results of a PCAOB inspection?

- a. The entire report issued by the PCAOB is publicly available.
- b. The portion of the report issued on a CPA firm's quality control is not ordinarily publicly available.
- c. The report issued is only available to Congress.
- d. The report is available only to PCAOB members.

41. Which of the following sets of standards does the Public Company Accounting Oversight Board **not** have the authority to establish for audits of public companies?

- a. Auditing standards.
- b. Quality control standards.
- c. Accounting standards.
- d. Independence standards.

F. International Standards—Ethical

42. In relation to the AICPA *Code of Professional Conduct*, the IFAC *Code of Ethics for Professional Accountants*

- a. Has more outright prohibitions.
- b. Has fewer outright prohibitions.
- c. Has no outright prohibitions.
- d. Applies only to professional accountants in business.

43. Based on the IFAC *Code of Ethics for Professional Accountants*, threats to independence arise from all of the following except:

- a. Self-interest.
- b. Advocacy.
- c. The audit relationship.
- d. Intimidation.

44. If an audit firm discovers threats to independence with respect to an audit engagement, the IFAC *Code of Ethics for Professional Accountants* indicates that the firm should

- a. Immediately resign from the engagement.
- b. Notify the appropriate regulatory body.
- c. Document the issue.
- d. Evaluate the significance of the threats and apply appropriate safeguards to reduce them to an acceptable level.

45. With respect to the acceptance of contingent fees for professional services, the IFAC *Code of Ethics for Professional Accountants* indicates that the accounting firm

- a. Should not accept contingent fees.
- b. Should establish appropriate safeguards around acceptance of a contingent fee.
- c. Should accept contingent fees only for assurance services other than audits of financial statements.
- d. Should accept contingent fees if it is customary in the country.

46. With regard to marketing professional services, the IFAC *Code of Ethics for Professional Accountants* indicates that

- a. Direct marketing is prohibited.
- b. Marketing is allowed if lawful.
- c. Marketing should be honest and truthful.
- d. Marketing of audit services is prohibited.

G. International Standards—Auditing/ Assurance

47. What body establishes international auditing standards?

- a. The Public Company Accounting Oversight Board.
- b. The International Federation of Accountants.
- c. The World Bank.
- d. The International Assurance Body.

48. Which of the following is **not** true about international auditing standards?

- a. International auditing standards do not require an audit of internal control.
- b. International auditing standards do not allow reference to division of responsibilities in the audit report.
- c. International auditing standards require obtaining an attorney's letter.
- d. International auditing standards are based on a risk assessment approach.

49. Which of the following is **most** likely to be required in an audit performed in conformity with international auditing standards?

- a. Confirmation of accounts receivable.
- b. Audit report modification for a change in accounting principles.
- c. An opinion on internal control.
- d. Audit report inclusion of the location in which the auditor practices.

H. Other (SEC, GAO, DOL)

50. Independence standards of the GAO for audits in accordance with generally accepted government auditing standards describe three types of impairments of independence. Which of the following is **not** one of these types of impairments?

- a. Personal.
- b. Organizational.

c. External.

d. Unusual.

51. In accordance with the independence standards of the GAO for performing audits in accordance with generally accepted government auditing standards, which of the following is **not** an example of an external impairment of independence?

- a. Reducing the extent of audit work due to pressure from management to reduce audit fees.
- b. Selecting audit items based on the wishes of an employee of the organization being audited.
- c. Bias in the items the auditors decide to select for testing.
- d. Influence by management on the personnel assigned to the audit.

52. Under the independence standards of the GAO for performing audits in accordance with generally accepted government auditing standards, which of the following are overreaching principles for determining whether a nonaudit service impairs independence?

- I. Auditors must not perform nonaudit services that involve performing management functions or making management decisions.
- II. Auditors must not audit their own work or provide nonaudit services in situations in which the nonaudit services are significant or material to the subject matter of the audit.
- III. Auditors must not perform nonaudit services which require independence.

a. I only.

b. I and II only.

c. I, II and III.

d. II and III only.

53. Which of the following bodies enforce the audit requirements of the Employee Retirement Security Act of 1974 (ERISA) with respect to employee benefit plans?

a. The Department of Labor.

b. The Department of Pension Management.

c. The Securities and Exchange Commission.

d. The Public Company Accounting Oversight Board.

54. The requirement for independence by the auditor regarding audits of employee benefit plans apply to the plan as well as

- a. Investment companies doing business with the plan.
- b. Members of the plan.
- c. The plan sponsor.
- d. The actuary firm doing services for the plan.

Multiple-Choice Answers and Explanations

Answers

1. c ___	14. d ___	27. a ___	40. b ___	53. a ___
2. a ___	15. a ___	28. d ___	41. c ___	54. c ___
3. d ___	16. a ___	29. c ___	42. b ___	
4. c ___	17. b ___	30. d ___	43. c ___	
5. d ___	18. b ___	31. a ___	44. d ___	
6. d ___	19. c ___	32. b ___	45. b ___	
7. b ___	20. a ___	33. b ___	46. c ___	
8. c ___	21. d ___	34. c ___	47. b ___	
9. c ___	22. b ___	35. c ___	48. c ___	
10. a ___	23. d ___	36. c ___	49. d ___	
11. d ___	24. c ___	37. a ___	50. d ___	
12. c ___	25. a ___	38. a ___	51. c ___	1st: ___/54 = ___%
13. b ___	26. b ___	39. b ___	52. b ___	2nd: ___/54 = ___%

Explanations

1. (c) The requirement is to identify the statement that **best** describes the meaning of generally accepted auditing standards. Answer (c) is correct because generally accepted auditing standards are defined as the Statements on Auditing Standards issued by the Auditing Standards Board. Answer (a) is incorrect because while GAAS includes various required and suggested procedures, their scope is broader than simply required procedures relating to gathering evidence. Answer (b) is incorrect because it represents a portion of the objective of the accounting profession's quality control standards, not generally accepted auditing standards. Answer (d) is incorrect because GAAS apply only to audits performed for nonissuers in the United States (e.g. PCAOB auditing standards apply to issuers and international auditing standards apply to audits performed under those standards.)

2. (a) The requirement is to identify a conceptual difference between the attestation standards and generally accepted auditing standards. Answer (a) is correct because the attestation standards apply for performing and reporting on examination, review, and agreed-upon procedures engagements (attestation engagements) that address subject matter other than historical financial statements. Answer (b) is incorrect because an independent mental attitude is required for attestation engagements. Answer (c) is incorrect because an attest engagement may be related to a business acquisition study or a feasibility study. Answer (d) is incorrect because both the attestation standards and generally accepted auditing standards include reviews.

3. (d) The requirement is to identify the reply which is **not** an attestation standard. Answer (d) is correct because the attestation standards do not include a requirement that a sufficient understanding of internal control be obtained to plan the engagement. There is no internal control standard because the concept of internal control may not be relevant to certain assertions on which a CPA may be engaged to report (e.g.,

aspects of information about computer software). Answers (a), (b), and (c) are all incorrect because standards exist for evidence, reporting on the assertion or subject matter, and proper planning.

4. (c) The requirement is to identify the characteristic that is **most** likely to be unique to the audit work of CPAs as compared to work performed by practitioners of other professions. Answer (c) is correct because independence is absolutely required for the performance of audits; other professions do not in general require such independence. Answers (a), (b), and (d) are incorrect because the various professions require due professional care and competence and have a complex body of knowledge.

5. (d) The requirement is to determine what is meant by the PCAOB's requirement of due care in the performance of an audit. Answer (d) is correct because due care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the audit. Answer (a) is incorrect because the due care standard does not directly address safeguards over access to assets and records. Answer (b) is incorrect because due care does not relate to a limited review of employee fraud and illegal acts. Answer (c) is incorrect because the first general standard addresses technical training and proficiency as an auditor.

6. (d) All of these events can result in the automatic expulsion of the member from the AICPA. Answer (a) is incorrect because although conviction of a crime is punishable by imprisonment for more than one year leads to automatic expulsion, it is not the only listed event that leads to automatic expulsion. Answers (b) and (c) are incorrect because all three can result in automatic expulsion from the AICPA.

7. (b) Answer (b) is correct because an effective corporate governance structure (e.g., an active audit committee), if implemented by a client, may mitigate a threat to CPA independence through appropriate decision making, oversight, and communications regarding services provided by the CPA

firm. Answer (a) is incorrect because it is a safeguard that is implemented by regulation or the CPA firm. Answer (c) is incorrect because it is a safeguard that is required by regulation or the CPA firm. Answer (d) is incorrect because a safeguard of independence would be a situation in which those charged with corporate governance, not management, select the CPA firm; management fulfilling that role may be viewed as a threat rather than a safeguard.

8. (c) Answer (c) is correct because the team member would be reviewing his or her own work. Answer (a) is incorrect because this is an example of a familiarity threat. Answer (b) is incorrect because this is an example of a safeguard to threats to independence. Answer (d) is incorrect because this represents a financial self-interest threat to independence.

9. (c) The AICPA's *Code of Professional Conduct* Independence Rule states that, a spouse may be employed by a client if s/he does not exert significant influence over the contents of the client's financial statements. This is a key position as defined by the *Code*.

10. (a) According to the Integrity and Objectivity Rule of the *Code of Professional Conduct*, in performing any professional service, a member shall maintain objectivity and integrity, avoid conflicts of interest, and not knowingly misrepresent facts. Answer (a) is correct as this would be knowingly misrepresenting the facts. Answers (b) and (d) are incorrect as these are not intentional misstatements. Answer (c) is incorrect because while one must remain objective while performing consulting services, independence is not required unless the CPA also performs attest services for that client.

11. (d) The requirement is to determine which act is generally prohibited. Answer (d) is correct because when an engagement is terminated prior to completion, the Acts Discreditable Rule states that a member is required to return only client records. Answer (a) is incorrect because issuing a modified report explaining a failure to follow a governmental regulatory agency's standards when conducting an attest service is not prohibited. Answer (c) is incorrect because accepting a contingent fee is allowable when representing a client in an examination by a revenue agent of the client's federal or state income tax return. Answer (b) is incorrect because revealing confidential client information during a quality review of a professional practice by a team from the state CPA society is not prohibited.

12. (c) According to *Code of Professional Conduct*, CPAs are allowed to depart from a GASB Statement only when results of the Standard would be misleading. Examples of possible circumstances justifying departure are new legislation and a new form of business transaction.

13. (b) The requirement is to determine whether a CPA may hire a non-CPA systems analyst and, if so, under what conditions. Answer (b) is correct because the *Code of Professional Conduct* allows such a situation when the CPA is qualified to supervise and evaluate the work of the specialist. Answer (a) is incorrect because the CPA need not be qualified to perform the specialist's tasks. Answer (c) is incorrect because non-CPA professionals are permitted to be associated with CPA firms in public practice. Answer (d) is incorrect because nonprofessionals

may be hired, and because developing computer systems is recognized as a service performed by public accountants.

14. (d) The requirement is to determine which reply is **not** a responsibility when an accountant concludes that a difference of opinion with a supervisor exists relating to a significant accounting matter. Answer (d) is correct because the profession does not have a "discreditable acts framework" to be used in such a manner. Answers (a), (b) and (c) are incorrect because the *Code of Professional Conduct* requires that accountants consider consulting legal counsel (answer (b)), determining other communication responsibilities (answer (b)), and documenting his understanding (answer (c)). Bill should also consider whether additional requirements exist under his firm's internal policies.

15. (a) The requirement is to determine the activity that would most likely **not** impair a CPA's independence. Accounting and consulting services do not normally impair independence because the member's role is advisory in nature. Answers (b) and (c) are incorrect because management functions are being performed. Answer (d) is incorrect because accepting a luxurious gift impairs a CPA's independence.

16. (a) The requirement is to identify the type of report that may be issued only by an independent accountant. Answer (a) is correct because the attestation standards require independence for the performance of all attestation engagements. An attestation engagement is one in which the accountant expresses a conclusion about the reliability of assertions which are the responsibility of another party. A standard report on an examination of a financial forecast requires the auditor to express an opinion, which requires an accountant to be independent. Answer (b) is incorrect because CS 100 indicates that consulting services are fundamentally different from the attestation function, and therefore do not require independence of the accountant. Answers (c) and (d) are incorrect because AR 100 indicates that an accountant who is not independent is not precluded from issuing a report on a compilation of financial statements.

17. (b) The *Code of Professional Conduct* requires a member to discharge professional responsibilities with competence and diligence. Yet, the competence requirement accepts that there are limitations to a member's capabilities—in such cases consultation or referral may be required when a professional engagement exceeds the personal competence of a member or a members firm. Accordingly it may be required to consult with experts in exercising due care. Obtaining a specialty credential is not required under the due diligence principle.

18. (b) The Integrity and Objectivity Rule of the AICPA *Code of Professional Conduct* requires that when a CPA is acting as an expert witness, s/he should **not** act as an advocate but should give his/her position based on objectivity. The expert witness does this based on specialized knowledge, training, and experience.

19. (c) The requirement is to determine which act is generally prohibited. Answer (c) is correct because "a member in public practice shall not for a commission recommend or refer to a

client any product or service, or for a commission recommend or refer any product or service to be supplied by a client, or receive a commission when the member or the member's firm perform for that client: (1) an audit of a financial statement; or (2) a compilation of a financial statement when the member expects that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or (3) an examination of prospective financial information." Answer (a) is incorrect because a member may purchase a product and resell it to a client. Any profit on sale would not constitute a commission.

20. (a) The principle of due care requires the member to observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge responsibility to the best of the member's ability. Answer (b) is incorrect as the auditor is not required to examine **all** corroborating evidence supporting management's assertions, but rather to examine evidence on a scope basis based on his/her consideration of materiality and level of risk assessed. Answer (c) is incorrect as the auditor should be aware of the possibility of illegal acts, but an audit provides no assurance that all or any illegal acts will be detected. Answer (d) is not the best answer because competence is derived from both education and experience. The principle of due care requires the member to strive to improve competence, however, attaining the proper balance of professional experience and formal education is not a criterion for exercising due care.

21. (d) The fact that a close relative of Kar works for Fort impairs Kar's independence. Answer (a) is incorrect because the gift is of a token amount which does not impair Kar's independence. Answer (b) is incorrect because a joint financial investment must be material to impair independence, and this would generally not occur with respect to a retirement plan. Answer (c) is incorrect because preparation of the client's tax return is not a service that impairs independence.

22. (b) Independence was not required at the time the loan was obtained, and because it is fully secured it is grandfathered by the *Code of Professional Conduct*. Answer (a) is incorrect because if the CPA is required to be independent, a mortgage loan would not be permitted even if it was fully secured. Answer (c) is incorrect because the CPA was not required to be independent of the client. Answer (d) is incorrect because the CPA was not required to be independent of the client.

23. (d) Both of the statements are incorrect; either would violate the Confidential Client Information Rule. Answer (a) is incorrect because statement I also is incorrect. Answer (b) is incorrect because statement II also is incorrect. Answer (c) is incorrect because statements I and II are both incorrect.

24. (c) Information in the CPA's working papers is confidential and may not be disclosed except with the client's consent or by court order. Answer (a) is incorrect because disclosure of the information would generally violate the Confidential Client Information Rule. Answers (b) and (d) are incorrect because the CPA owns the working papers.

25. (a) The requirement is to identify the listed authoritative body designated to promulgate attestation standards. Answer (a) is correct because only the Auditing Standards Board, the

Accounting and Review Services Committee, and the Management Consulting Services Executive Committee have been authorized to promulgate attestation standards.

26. (b) The requirement is to determine the proper method for handling a difference of opinion between auditors concerning interpretation of the results of an auditing procedure. Answer (b) is correct because the quality control standards allow such documentation of the considerations involved in the resolution of differences of opinion. Answer (a) is incorrect because the AICPA does not, in general, rule on disagreements of this nature. Answer (c) is incorrect because the disagreement relates to an auditing procedure and therefore in most such circumstances the entity's management or its audit committee will have no particular expertise. Answer (d) is incorrect because the disagreement need not necessarily be reported to a peer review "monitoring" team.

27. (a) The requirement is to determine the factors that affect the nature and extent of a CPA firm's quality control policies and procedures. Answer (a) is correct because the nature and extent of a firm's quality control policies and procedures depend on a number of factors, including its size, the degree of operating autonomy allowed to its personnel and practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.

28. (d) The requirement is to identify the manners in which a CPA firm may communicate its quality control policies and procedures to its personnel. Answer (d) is correct because the requirements relating to quality control standard documentation state that either orally or written are acceptable. Answers (a), (b) and (c) all include one or more inappropriate "no" replies.

29. (c) The requirement is to identify the reply that is **not** one of the elements of quality control. Answer (c) is correct because there is no quality control element on internal control. Acceptance of client relationships and specific engagements (a), human resources (b), and monitoring (d) are all elements of quality control. In addition, the following also are elements of quality control: leadership responsibilities for engagement performance, quality within the firm, and relevant ethical requirements.

30. (d) The requirement is to determine the types of services to which Statements on Quality Control Standards apply. Answer (d) is correct because the standards explicitly limit application to auditing and accounting and review services. Although the quality control standards may be applied to other segments of a firm's practice (e.g., management advisory services and tax), the standards do not require it.

31. (a) The requirement is to determine how a CPA firm obtains reasonable assurance of providing professional services that conform with professional standards. Answer (a) is correct because a system of quality control is designed to provide a CPA firm with reasonable assurance of meeting its responsibility to provide professional services that conform with professional standards. Answer (b) is incorrect because a peer review provides information on whether a CPA firm is following an appropriate system of quality control. Answer (c) is incorrect because it is less complete than answer (a) since

continuing professional education helps achieve the specific quality control element of professional development. Answer (d) is incorrect because the financial statements comply with generally accepted accounting principles, not the professional services provided by the CPA firm.

32. (b) The requirement is to identify the correct statement concerning PCAOB guidance that uses the term “should.” Answer (a) is correct because the term “should” means that the auditor must comply with the requirements unless he or she can demonstrate that alternative actions were sufficient to achieve the objectives of the standards. Answer (a) is incorrect because terms such as “must,” “shall,” and “is required to” are used to indicate that the auditor must fulfill the responsibilities. Answer (c) is incorrect because terms such as “may,” “might,” and “could” are used when the auditor should consider performing the audit procedure. Answer (d) is incorrect because no particular terms are used for the situation in which the auditor has complete discretion whether to perform the procedure.

33. (b) The requirement is to determine how long audit working papers must be saved under the requirements of the Sarbanes-Oxley Act. Answer (b) is correct, 7 years. Answers (a), (c), and (d) are incorrect because a 7-year limit exists for most working papers.

34. (c) The requirement is to identify the organization established by the Sarbanes-Oxley Act. Answer (c) is correct because SOX did establish the Public Company Accounting Oversight Board. Answer (a) is incorrect because the Auditing Standards Board is the AICPA’s auditing standards setting organization. Answer (b) is incorrect because there is no organization titled the Accounting Enforcement Releases Board. Answer (d) is incorrect because the Securities and Exchange Commission was established in 1934 by the Securities Exchange Act.

35. (c) The requirement is to identify the type of service an auditor of an issuer **cannot** legally perform under Title II of the Sarbanes-Oxley Act. Answer (c) is correct because the auditor may not provide internal audit outsourcing services to the issuer. Answer (a) is incorrect because tax services may be performed. Answer (b) is incorrect because a review of interim information is required to be performed. Answer (d) is incorrect because, for large companies, the audit of internal control over financial reporting is required as a part of the integrated audit.

36. (c) The requirement is to identify a limitation for the audit partner in charge of an audit of a public company. Answer (c) is correct as the partner may only be in charge for five consecutive years. Answer (a) is incorrect since there is no such restriction. Answer (b) is incorrect because another partner must perform the second partner review function. Answer (d) is incorrect because the AICPA has no such accreditation.

37. (a) The requirement is to identify the correct statement concerning membership on the Public Company Accounting Oversight Board. Answer (a) is correct because the five-member board may have no more than two CPA members. Answer (b) is incorrect because the PCAOB is composed of five members. Answer (c) is incorrect because no members

may be currently active in public accounting. Answer (d) is incorrect because there is no rule that a majority of members must be or must have been accounting educators.

38. (a) The requirement is to identify the type of standards for which the PCAOB is **not** responsible. Answer (a) is correct because the PCAOB has no responsibility for promulgating or adopting accounting standards. Answer (b) is incorrect because the PCAOB does have responsibility for attestation standards relating to public companies. Answer (c) is incorrect because the PCAOB does have responsibility for auditing standards relating to public companies. Answer (d) is incorrect because the PCAOB does have responsibility for quality control standards relating to public companies.

39. (b) The requirement is to identify a PCAOB engagement that focuses on a selected quality control issue. Answer (b) is correct because Section 104 of the Sarbanes-Oxley requires that the PCAOBs evaluate the sufficiency of a CPA firm’s quality control system as a part of an inspection. Answer (a) is incorrect because a financial statement audit focuses on the fairness of presentation of financial statements. Answer (c) is incorrect because peer reviews ordinarily relate to AICPA and state oversight of CPA firms. Answer (d) is incorrect because there is no engagement referred to as quality control.

40. (b) The requirement is to identify the correct statement concerning communication of the results of a PCAOB inspection. Answer (b) is correct since the portion of the report issued on a CPA firm’s quality control is not ordinarily publicly available. Answer (a) is incorrect because the portion of the report on a CPA firm’s quality control is not ordinarily made available. Answer (c) is incorrect because most of the report (other than the portion on the CPA firm’s quality control) is publicly available. Answer (d) is incorrect because most of the report (other than the portion on the CPA firm’s quality control) is publicly available.

41. (c) The requirement is to determine the set of standards that the PCAOB does **not** have authority to establish. Answer (c) is correct because the FASB establishes accounting standards for both public and nonpublic companies. Answer (a) is incorrect because the PCAOB has authority to issue auditing standards. Answer (b) is incorrect because the PCAOB has the authority to issue quality control standards. Answer (d) is incorrect because the PCAOB has the authority to issue independence standards.

42. (b) The requirement is to identify the characteristic that differs between the two sets of ethical standards. Answer (b) is correct because the IFAC Code has fewer outright prohibitions than the AICPA Code. Answers (a) and (c) are incorrect because the IFAC Code has fewer outright prohibitions. Answer (d) is incorrect because the IFAC Code applies to all professional accountants.

43. (c) The requirement is to identify the item that is not a threat to independence. Answer (c) is correct because the audit relationship, in itself, is not a threat to independence. Answers (a), (b), and (d) are incorrect because they all represent types of threats to independence.

44. (d) The requirement is to identify the appropriate course of action when threats to independence are discovered. Answer (d) is correct because the firm should evaluate the significance of the threats and apply safeguards, if necessary, to reduce them to an acceptable level. Answer (a) is incorrect because the firm would only resign if appropriate safeguards could not reduce the threats to an acceptable level, or it is required based on a prohibition. Answer (b) is incorrect because the firm would not notify a regulatory body at this point. Answer (c) is incorrect because the firm would document the issue, but only after it is resolved.

45. (b) The requirement is to identify what the IFAC Code of Ethics for Professional Accountants provides with respect to contingent fees. Answer (b) is correct because the IFAC Code indicates that if the contingent fee presents a threat to apply fundamental principles, the firm should establish appropriate safeguards. Answer (a) is incorrect because a contingent fee may be accepted if threats can be reduced to an acceptable level. Answers (c) and (d) are incorrect because the IFAC Code does not contain these provisions.

46. (c) The requirement is to identify the IFAC Code provision regarding marketing. Answer (c) is correct because the IFAC Code indicates the marketing must be honest and truthful. Answers (a) and (d) are incorrect because no particular form of marketing is prohibited. Answer (b) is incorrect because marketing must be honest and truthful as well as legal.

47. (b) The requirement is to identify the body that establishes international auditing standards. Answer (b) is correct because the International Auditing and Assurance Standards Board of the International Federation of Accountants establishes international auditing standards. Answer (a) is incorrect because the Public Company Accounting Oversight Board establishes standards for the audit of public companies in the US. Answers (c) and (d) are incorrect because these bodies do not establish auditing standards.

48. (c) The requirement is to identify the item that is **not** true about international auditing standards. Answer (c) is correct because international auditing standards require obtaining an attorney's letter only if the auditors assess a risk of material misstatement. Answers (a), (b) and (d) are incorrect because they are all true about international auditing standards.

49. (d) The requirement is to identify the **most** likely requirement in an audit performed in conformity with international auditing standards. Answer (d) is correct because

audit reports based on international auditing standards must include the location in which the auditor practices (i.e., the city and country). Answer (a) is incorrect because whether accounts receivable are confirmed is based on the auditor's consideration of the assessed risk of material misstatement and how the audit evidence will, from other planned audit procedures, reduce that risk. Answer (b) is incorrect because audit report modification for a change in accounting principles is not required under international auditing standards. Answer (c) is incorrect because an opinion on internal control is not required under international auditing standards.

50. (d) The requirement is to identify the impairment that is **not** one of the three types of impairments described in the GAO standards. Answer (d) is correct because an unusual impairment is not one of the types of impairments described in the GAO standards. Answers (a), (b), and (c) are incorrect because they are the three types of impairments described in the GAO standards.

51. (c) The requirement is to identify the example that does **not** represent an external impairment of independence. Answer (c) is correct because this item is an example of a personal impairment of independence. Answers (a), (b) and (d) are incorrect because they are all examples of external impairments of independence.

52. (b) The requirement is to identify the overreaching principles for identifying whether nonaudit services impair independence. Answer (b) is correct because I and II are the two principles. Answer (a) is incorrect because II is also an overreaching principle. Answer (c) is incorrect because III is not an overreaching principle. Answer (d) is incorrect because I is an overreaching principle and III is not.

53. (a) The requirement is to identify the body that enforces the audit requirements of ERISA. Answer (a) is correct because the Department of Labor is responsible for enforcing the audit requirements. Answer (b) is incorrect because the Department of Pension Management does not exist. Answers (c) and (d) are incorrect because the SEC and the PCAOB deal with auditing requirements for entities with publicly traded securities (issuers).

54. (c) The requirement is to identify the party that independence standards also apply to when performing an audit of an employee benefit plan. Answer (c) is correct because the Department of Labor rules also apply to independence from the plan and the plan sponsor. Answers (a), (b) and (d) are incorrect because the independence standards do not apply to these parties.

Multiple-Choice Questions (1–115)

A.1. Financial Statement Assertions

1. Financial statement assertions are established for account balances,

	Classes of transactions	Disclosures
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

2. Which of the following is **not** a financial statement assertion relating to account balances?

- Completeness.
- Existence.
- Rights and obligations.
- Valuation and competence.

A.2. Audit Risk

3. As the acceptable level of detection risk decreases, an auditor may

- Reduce substantive testing by relying on the assessments of inherent risk and control risk.
- Postpone the planned timing of substantive tests from interim dates to the year-end.
- Eliminate the assessed level of inherent risk from consideration as a planning factor.
- Lower the assessed level of control risk from the maximum level to below the maximum.

4. The risk that an auditor will conclude, based on substantive tests, that a material misstatement does **not** exist in an account balance when, in fact, such misstatement does exist is referred to as

- Sampling risk.
- Detection risk.
- Nonsampling risk.
- Inherent risk.

5. As the acceptable level of detection risk decreases, the assurance directly provided from

- Substantive tests should increase.
- Substantive tests should decrease.
- Tests of controls should increase.
- Tests of controls should decrease.

6. Which of the following audit risk components may be assessed in nonquantitative terms?

	Control risk	Detection risk	Inherent risk
a.	Yes	Yes	No
b.	Yes	No	Yes
c.	Yes	Yes	Yes
d.	No	Yes	Yes

7. Inherent risk and control risk differ from detection risk in that they

- Arise from the misapplication of auditing procedures.
- May be assessed in either quantitative or nonquantitative terms.
- Exist independently of the financial statement audit.
- Can be changed at the auditor's discretion.

8. On the basis of the audit evidence gathered and evaluated, an auditor decides to increase the assessed level of control risk from that originally planned. To achieve an overall audit risk level that is substantially the same as the planned audit risk level, the auditor would

- Decrease substantive testing.
- Decrease detection risk.
- Increase inherent risk.
- Increase materiality levels.

9. Relationship between control risk and detection risk is ordinarily

- Parallel.
- Inverse.
- Direct.
- Equal.

A.3. Materiality

10. Which of the following would an auditor **most** likely use in determining the auditor's preliminary judgment about materiality?

- The anticipated sample size of the planned substantive tests.
- The entity's annualized interim financial statements.
- The results of the internal control questionnaire.
- The contents of the management representation letter.

11. Which of the following statements is **not** correct about materiality?

- The concept of materiality recognizes that some matters are important for fair presentation of financial statements in conformity with GAAP, while other matters are not important.
- An auditor considers materiality for planning purposes in terms of the largest aggregate level of misstatements that could be material to any one of the financial statements.
- Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative judgments.
- An auditor's consideration of materiality is influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements.

12. Which of the following is a function of the risks of material misstatement and detection risk?

- Internal control.
- Corroborating evidence.

- c. Quality control.
d. Audit risk.
13. Which of the following is correct concerning performance materiality on an audit?
- It will ordinarily be less than financial statement materiality.
 - It should be established at beginning of an audit and not be revised thereafter.
 - It should be established at separate amounts for the various financial statements.
 - It need not be documented in the working papers.
14. Which of the following would an auditor **most** likely use in determining the auditor's preliminary judgment about materiality?
- The results of the initial assessment of control risk.
 - The anticipated sample size for planned substantive tests.
 - The entity's financial statements of the prior year.
 - The assertions that are embodied in the financial statements.
15. Holding other planning considerations equal, a decrease in the amount of misstatement in a class of transactions that an auditor could tolerate **most** likely would cause the auditor to
- Apply the planned substantive tests prior to the balance sheet date.
 - Perform the planned auditing procedures closer to the balance sheet date.
 - Increase the assessed level of control risk for relevant financial statement assertions.
 - Decrease the extent of auditing procedures to be applied to the class of transactions.
16. When issuing an unmodified opinion, the auditor who evaluates the audit findings should be satisfied that the
- Amount of known misstatement is documented in the management representation letter.
 - Estimate of the total likely misstatement is less than a material amount.
 - Amount of known misstatement is acknowledged and recorded by the client.
 - Estimate of the total likely misstatement includes the adjusting entries already recorded by the client.
18. Which of the following **best** describes what is meant by the term "fraud risk factor?"
- Factors whose presence indicates that the risk of fraud is high.
 - Factors whose presence often have been observed in circumstances where frauds have occurred.
 - Factors whose presence requires modification of planned audit procedures.
 - Material weaknesses identified during an audit.
19. Which of the following is correct concerning requirements about auditor communications about fraud?
- Fraud that involves senior management should be reported directly to the audit committee regardless of the amount involved.
 - Fraud with a material effect on the financial statements should be reported directly by the auditor to the Securities and Exchange Commission.
 - Fraud with a material effect on the financial statements should ordinarily be disclosed by the auditor through use of an "emphasis of a matter" paragraph added to the audit report.
 - The auditor has no responsibility to disclose fraud outside the entity under any circumstances.
20. When performing a financial statement audit, auditors are required to explicitly assess the risk of material misstatement due to
- Errors.
 - Fraud.
 - Illegal acts.
 - Business risk.
21. Audits of financial statements are designed to obtain assurance of detecting misstatement due to

	Errors	Fraudulent financial reporting	Misappropriation of assets
a.	Yes	Yes	Yes
b.	Yes	Yes	No
c.	Yes	No	Yes
d.	No	Yes	No

22. An auditor is unable to obtain absolute assurance that misstatements due to fraud will be detected for all of the following **except**

A.4. Errors and Fraud

17. Which of the following is an example of fraudulent financial reporting?
- Company management changes inventory count tags and overstates ending inventory, while understating cost of goods sold.
 - The treasurer diverts customer payments to his personal due, concealing his actions by debiting an expense account, thus overstating expenses.
 - An employee steals inventory and the "shrinkage" is recorded in cost of goods sold.
 - An employee steals small tools from the company and neglects to return them; the cost is reported as a miscellaneous operating expense.
23. An attitude that includes a questioning mind and a critical assessment of audit evidence is referred to as
- Due professional care.
 - Professional skepticism.
 - Reasonable assurance.
 - Supervision.

24. Professional skepticism requires that an auditor assume that management is

- a. Honest, in the absence of fraud risk factors.
- b. Dishonest until completion of audit tests.
- c. Neither honest nor dishonest.
- d. Offering reasonable assurance of honesty.

25. The most difficult type of misstatement to detect is fraud based on

- a. The overrecording of transactions.
- b. The nonrecording of transactions.
- c. Recorded transactions in subsidiaries.
- d. Related-party receivables.

26. When considering fraud risk factors relating to management's characteristics, which of the following is **least** likely to indicate a risk of possible misstatement due to fraud?

- a. Failure to correct known significant deficiency on a timely basis.
- b. Nonfinancial management's preoccupation with the selection of accounting principles.
- c. Significant portion of management's compensation represented by bonuses based upon achieving unduly aggressive operating results.
- d. Use of unusually conservative accounting practices.

27. Which of the following conditions identified during fieldwork of an audit is **most** likely to affect the auditor's assessment of the risk of misstatement due to fraud?

- a. Checks for significant amounts outstanding at year-end.
- b. Computer generated documents.
- c. Missing documents.
- d. Year-end adjusting journal entries.

28. Which of the following is **most** likely to be a response to the auditor's assessment that the risk of material misstatement due to fraud for the existence of inventory is high?

- a. Observe test counts of inventory at certain locations on an unannounced basis.
- b. Perform analytical procedures rather than taking test counts.
- c. Request that inventories be counted prior to year-end.
- d. Request that inventory counts at the various locations be counted on different dates so as to allow the same auditor to be present at every count.

29. Which of the following is **most** likely to be an example of fraud?

- a. Defalcations occurring due to invalid electronic approvals.
- b. Mistakes in the application of accounting principles.
- c. Mistakes in processing data.
- d. Unreasonable accounting estimates arising from oversight.

30. Which of the following characteristics **most** likely would heighten an auditor's concern about the risk of intentional manipulation of financial statements?

- a. Turnover of senior accounting personnel is low.
- b. Insiders recently purchased additional shares of the entity's stock.
- c. Management places substantial emphasis on meeting earnings projections.
- d. The rate of change in the entity's industry is slow.

31. Which of the following statements reflects an auditor's responsibility for detecting misstatements due to errors and fraud?

- a. An auditor is responsible for detecting employee errors and simple fraud, but not for discovering fraud involving employee collusion or management override.
- b. An auditor should plan the audit to detect misstatements due to errors and fraud that are caused by departures from GAAP.
- c. An auditor is not responsible for detecting misstatements due to errors and fraud unless the application of GAAS would result in such detection.
- d. An auditor should design the audit to provide reasonable assurance of detecting misstatements due to errors and fraud that are material to the financial statements.

32. Disclosure of fraud to parties other than a client's senior management and its audit committee or board of directors ordinarily is **not** part of an auditor's responsibility. However, to which of the following outside parties may a duty to disclose fraud exist?

	To the SEC when the client reports an auditor change	To a successor auditor when the successor makes appropriate inquiries	To a government funding agency from which the client receives financial assistance
a.	Yes	Yes	No
b.	Yes	No	Yes
c.	No	Yes	Yes
d.	Yes	Yes	Yes

33. Under Statements on Auditing Standards, which of the following would be classified as an error?

- a. Misappropriation of assets for the benefit of management.
- b. Misinterpretation by management of facts that existed when the financial statements were prepared.

- c. Preparation of records by employees to cover a fraudulent scheme.
- d. Intentional omission of the recording of a transaction to benefit a third party.

34. What assurance does the auditor provide that misstatements due to errors, fraud, and direct effect illegal acts that are material to the financial statements will be detected?

	Errors	Fraud	Direct effect of illegal acts
a.	Limited	Negative	Limited
b.	Limited	Limited	Reasonable
c.	Reasonable	Limited	Limited
d.	Reasonable	Reasonable	Reasonable

35. Because of the risk of material misstatement, an audit of financial statements in accordance with generally accepted auditing standards should be planned and performed with an attitude of

- a. Objective judgment.
- b. Independent integrity.
- c. Professional skepticism.
- d. Impartial conservatism.

36. Which of the following most accurately summarizes what is meant by the term “material misstatement?”

- a. Fraud and direct-effect illegal acts.
- b. Fraud involving senior management and material fraud.
- c. Material error, material fraud, and certain illegal acts.
- d. Material error and material illegal acts.

37. Which of the following statements **best** describes the auditor’s responsibility to detect conditions relating to financial stress of employees or adverse relationships between a company and its employees?

- a. The auditor is required to plan the audit to detect these conditions on all audits.
- b. These conditions relate to fraudulent financial reporting, and an auditor is required to plan the audit to detect these conditions when the client is exposed to a risk of misappropriation of assets.
- c. The auditor is required to plan the audit to detect these conditions whenever they may result in misstatements.
- d. The auditor is not required to plan the audit to discover these conditions, but should consider them if he or she becomes aware of them during the audit.

38. When the auditor believes a misstatement is or may be the result of fraud but that the effect of the misstatement is not material to the financial statements, which of the following steps is required?

- a. Consider the implications for other aspects of the audit.
- b. Resign from the audit.

- c. Commence a fraud examination.
- d. Contact regulatory authorities.

39. Which of the following statements is correct relating to the auditor’s consideration of fraud?

- a. The auditor’s interest in fraud consideration relates to fraudulent acts that cause a material misstatement of financial statements.
- b. A primary factor that distinguishes fraud from error is that fraud is always intentional, while errors are generally, but not always, intentional.
- c. Fraud always involves a pressure or incentive to commit fraud, and a misappropriation of assets.
- d. While an auditor should be aware of the possibility of fraud, management, and not the auditor, is responsible for detecting fraud.

40. Which of the following factors or conditions is an auditor **least** likely to plan an audit to discover?

- a. Financial pressures affecting employees.
- b. High turnover of senior management.
- c. Inadequate monitoring of significant controls.
- d. Inability to generate positive cash flows from operations.

41. At which stage(s) of the audit may fraud risk factors be identified?

	Planning	Obtaining understanding	Conducting fieldwork
a.	Yes	Yes	Yes
b.	Yes	Yes	No
c.	Yes	No	No
d.	No	Yes	Yes

42. Management’s attitude toward aggressive financial reporting and its emphasis on meeting projected profit goals **most** likely would significantly influence an entity’s control environment when

- a. External policies established by parties outside the entity affect its accounting practices.
- b. Management is dominated by one individual who is also a shareholder.
- c. Internal auditors have direct access to the board of directors and the entity’s management.
- d. The audit committee is active in overseeing the entity’s financial reporting policies.

43. Which of the following is **least** likely to be required on an audit?

- a. Test appropriateness of journal entries and adjustment.
- b. Review accounting estimates for biases.
- c. Evaluate the business rationale for significant unusual transactions.
- d. Make a legal determination of whether fraud has occurred.

44. Which of the following is **most** likely to be an overall response to fraud risks identified in an audit?

- a. Supervise members of the audit team less closely and rely more upon judgment.

b. Use less predictable audit procedures.

- c. Only use certified public accountants on the engagement.
- d. Place increased emphasis on the audit of objective transactions rather than subjective transactions.

45. Which of the following is **least** likely to be included in an auditor's inquiry of management while obtaining information to identify the risks of material misstatement due to fraud?

a. Are financial reporting operations controlled by and limited to one location?

- b. Does it have knowledge of fraud or suspect fraud?
- c. Does it have programs to mitigate fraud risks?
- d. Has it reported to the audit committee the nature of the company's internal control?

46. Individuals who commit fraud are ordinarily able to rationalize the act and also have an

	Incentive	Opportunity
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

47. What is an auditor's responsibility who discovers management involved in what is financially immaterial fraud?

a. Report the fraud to the audit committee.

- b. Report the fraud to the Public Company Oversight Board.
- c. Report the fraud to a level of management at least one below those involved in the fraud.
- d. Determine that the amounts involved are immaterial, and if so, there is no reporting responsibility.

48. Which of the following is **most** likely to be considered a risk factor relating to fraudulent financial reporting?

- a. Domination of management by top executives.
- b. Large amounts of cash processed.
- c. Negative cash flows from operations.
- d. Small high-dollar inventory items.

49. Which of the following is **most** likely to be presumed to represent fraud risk on an audit?

- a. Capitalization of repairs and maintenance into the property, plant, and equipment asset account.
- b. Improper revenue recognition.
- c. Improper interest expense accrual.
- d. Introduction of significant new products.

50. An auditor who discovers that a client's employees paid small bribes to municipal officials **most** likely would withdraw from the engagement if

- a. The payments violated the client's policies regarding the prevention of illegal acts.
- b. The client receives financial assistance from a federal government agency.
- c. Documentation that is necessary to prove that the bribes were paid does not exist.
- d. Management fails to take the appropriate remedial action.

51. Which of the following factors **most** likely would cause a CPA to **not** accept a new audit engagement?

- a. The prospective client has already completed its physical inventory count.
- b. The CPA lacks an understanding of the prospective client's operation and industry.
- c. The CPA is unable to review the predecessor auditor's working papers.
- d. The prospective client is unwilling to make all financial records available to the CPA.

52. Which of the following factors would **most** likely heighten an auditor's concern about the risk of fraudulent financial reporting?

- a. Large amounts of liquid assets that are easily convertible into cash.
- b. Low growth and profitability as compared to other entities in the same industry.
- c. Financial management's participation in the initial selection of accounting principles.
- d. An overly complex organizational structure involving unusual lines of authority.

A.5. Laws and Regulations

53. An auditor who discovers that a client's employees have paid small bribes to public officials **most** likely would withdraw from the engagement if the

- a. Client receives financial assistance from a federal government agency.
- b. Evidence that is necessary to prove that the illegal acts were committed does not exist.
- c. Employees' actions affect the auditor's ability to rely on management's representations.
- d. Notes to the financial statements fail to disclose the employees' actions.

54. Which of the following illegal acts should an audit be designed to obtain reasonable assurance of detecting?

- a. Securities purchased by relatives of management based on knowledge of inside information.
- b. Accrual and billing of an improper amount of revenue under government contracts.
- c. Violations of antitrust laws.
- d. Price fixing.

55. Which of the following relatively small misstatements **most** likely could have a material effect on an entity's financial statements?

- a. An illegal payment to a foreign official that was not recorded.
- b. A piece of obsolete office equipment that was not retired.
- c. A petty cash fund disbursement that was not properly authorized.
- d. An uncollectible account receivable that was not written off.

56. During the annual audit of Ajax Corp., a publicly held company, Jones, CPA, a continuing auditor, determined that illegal political contributions had been made during each of the past seven years, including the year under audit. Jones notified the board of directors about the illegal contributions, but they refused to take any action because the amounts involved were immaterial to the financial statements. Jones should reconsider the intended degree of reliance to be placed on the

- a. Letter of audit inquiry to the client's attorney.
- b. Prior years' audit plan.
- c. Management representation letter.
- d. Preliminary judgment about materiality levels.

57. The **most** likely explanation why the auditor's examination **cannot** reasonably be expected to bring noncompliance with all laws by the client to the auditor's attention is that

- a. Illegal acts are perpetrated by management override of internal control.
- b. Illegal acts by clients often relate to operating aspects rather than accounting aspects.
- c. The client's internal control may be so strong that the auditor performs only minimal substantive testing.
- d. Illegal acts may be perpetrated by the only person in the client's organization with access to both assets and the accounting records.

58. If specific information comes to an auditor's attention that implies noncompliance with laws that could result in a material, but indirect effect on the financial statements, the auditor should next

- a. Apply audit procedures specifically directed to ascertaining whether noncompliance has occurred.
- b. Seek the advice of an informed expert qualified to practice law as to possible contingent liabilities.
- c. Report the matter to an appropriate level of management at least one level above those involved.
- d. Discuss the evidence with the client's audit committee, or others with equivalent authority and responsibility.

59. An auditor who discovers that client employees have committed an illegal act that has a material effect on the client's financial statements **most** likely would withdraw from the engagement if

- a. The illegal act is a violation of generally accepted accounting principles.
- b. The client does not take the remedial action that the auditor considers necessary.
- c. The illegal act was committed during a prior year that was not audited.
- d. The auditor has already assessed control risk at the maximum level.

60. Under the Private Securities Litigation Reform Act of 1995, Baker, CPA, reported certain uncorrected illegal acts to Supermart's board of directors. Baker believed that failure to take remedial action would warrant a qualified audit opinion because the illegal acts had a material effect on Supermart's financial statements. Supermart failed to take appropriate remedial action and the board of directors refused to inform the SEC that it had received such

notification from Baker. Under these circumstances, Baker is required to

- a. Resign from the audit engagement within ten business days.
- b. Deliver a report concerning the illegal acts to the SEC within one business day.
- c. Notify the stockholders that the financial statements are materially misstated.
- d. Withhold an audit opinion until Supermart takes appropriate remedial action.

B. Audit Planning

61. Which of the following would be **least** likely to be considered an audit planning procedure?

- a. Use an engagement letter.
- b. Develop the overall audit strategy.
- c. Perform risk assessment.
- d. Develop the audit plan.

62. Which of the following factors would most likely cause a CPA to decide **not** to accept a new audit engagement?

- a. The CPA's lack of understanding of the prospective client's internal auditor's computer-assisted audit techniques.
- b. Management's disregard of its responsibility to maintain an adequate internal control environment.
- c. The CPA's inability to determine whether related-party transactions were consummated on terms equivalent to arm's-length transactions.
- d. Management's refusal to permit the CPA to perform substantive tests before the year-end.

B.1 Communicate with Predecessor Auditors

63. Before accepting an engagement to audit a new client, a CPA is required to obtain

- a. An understanding of the prospective client's industry and business.
- b. The prospective client's signature to the engagement letter.
- c. A preliminary understanding of the prospective client's control environment.
- d. The prospective client's consent to make inquiries of the predecessor auditor, if any.

64. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding

- a. Disagreements the predecessor had with the client concerning auditing procedures and accounting principles.
- b. The predecessor's evaluation of matters of continuing accounting significance.
- c. The degree of cooperation the predecessor received concerning the inquiry of the client's lawyer.
- d. The predecessor's assessments of inherent risk and judgments about materiality.

65. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding the predecessor's

- Opinion of any subsequent events occurring since the predecessor's audit report was issued.
- Understanding as to the reasons for the change of auditors.
- Awareness of the consistency in the application of GAAP between periods.
- Evaluation of all matters of continuing accounting significance.

B.2. Establishing an Understanding with the Client (Engagement Letters)

66. An auditor is required to establish an understanding with a client regarding the services to be performed for each engagement. This understanding generally includes

- Management's responsibility for errors and the illegal activities of employees that may cause material misstatement.
- The auditor's responsibility for ensuring that the audit committee is aware of any significant deficiencies in internal control that come to the auditor's attention.
- Management's responsibility for providing the auditor with an assessment of the risk of material misstatement due to fraud.
- The auditor's responsibility for determining preliminary judgments about materiality and audit risk factors.

67. Which of the following matters is generally included in an auditor's engagement letter?

- Management's responsibility for the entity's compliance with laws and regulations.
- The factors to be considered in setting preliminary judgments about materiality.
- Management's vicarious liability for illegal acts committed by its employees.
- The auditor's responsibility to search for significant internal control deficiencies.

68. During the initial planning phase of an audit, a CPA **most** likely would

- Identify specific internal control activities that are likely to prevent fraud.
- Evaluate the reasonableness of the client's accounting estimates.
- Discuss the timing of the audit procedures with the client's management.
- Inquire of the client's attorney as to whether any unrecorded claims are probable of assertion.

69. Which of the following statements would **least** likely appear in an auditor's engagement letter?

- Fees for our services are based on our regular per diem rates, plus travel and other out-of-pocket expenses.
- During the course of our audit we may observe opportunities for economy in, or improved controls over, your operations.

c. Our engagement is subject to the risk that material misstatements or fraud, if they exist, will not be detected.

- After performing our preliminary analytical procedures we will discuss with you the other procedures we consider necessary to complete the engagement.

70. Which of the following documentation is **not** required for an audit in accordance with generally accepted auditing standards?

- A written audit plan setting forth the procedures necessary to accomplish the audit's objectives.
- An indication that the accounting records agree or reconcile with the financial statements.
- A client engagement letter that summarizes the timing and details of the auditor's planned fieldwork.
- The assessment of the risks of material misstatement.

71. An engagement letter should ordinarily include information on the objectives of the engagement and

	CPA responsibilities	Client responsibilities	Limitation of engagement
a.	Yes	Yes	Yes
b.	Yes	No	Yes
c.	Yes	No	No
d.	No	No	No

72. Arrangements concerning which of the following are **least** likely to be included in engagement letter?

- A predecessor auditor.
- Fees and billing.
- CPA investment in client securities.
- Other services to be provided in addition to the audit.

B.3. Preliminary Engagement Activities

73. The auditor should document the understanding established with a client through a(n)

- Oral communication with the client.
- Written communication with the client.
- Written or oral communication with the client.
- Completely detailed audit plan.

74. Which of the following factors **most** likely would influence an auditor's determination of the auditability of an entity's financial statements?

- The complexity of the accounting system.
- The existence of related-party transactions.
- The adequacy of the accounting records.
- The operating effectiveness of control procedures.

B.4. Developing an Overall Strategy

75. Which of the following is **most** likely to require special planning considerations related to asset valuation?

- Inventory is comprised of diamond rings.
- The client has recently purchased an expensive copy machine.

- c. Assets costing less than \$250 are expensed even when the expected life exceeds one year.
- d. Accelerated depreciation methods are used for amortizing the costs of factory equipment.

76. A CPA wishes to determine how various publicly held companies have complied with the disclosure requirements of a new financial accounting standard. Which of the following information sources would the CPA **most** likely consult for information?

- a. AICPA *Codification of Statements on Auditing Standards*.
- b. AICPA *Accounting Trends and Techniques*.
- c. SEC Quality Control Review.
- d. SEC Statement 10-K Guide.

B.5. The Audit Plan

77. An auditor should design the audit plan so that

- a. All material transactions will be selected for substantive testing.
- b. Substantive tests prior to the balance sheet date will be minimized.
- c. The audit procedures selected will achieve specific audit objectives.
- d. Each account balance will be tested under either tests of controls or tests of transactions.

78. The audit plan generally is modified when

- a. Results of tests of control differ from expectations.
- b. An engagement letter has been signed by the auditor and the client.
- c. A significant deficiency has been communicated to the audit committee of the board of directors.
- d. The search for unrecorded liabilities has been performed and obtained results as had been expected during the planning of the audit.

79. Audit plans should be designed so that

- a. Most of the required procedures can be performed as interim work.
- b. Inherent risk is assessed at a sufficiently low level.
- c. The auditor can make constructive suggestions to management.
- d. The audit evidence gathered supports the auditor's conclusions.

80. In designing written audit plans, an auditor should establish specific audit objectives that relate primarily to the

- a. Timing of audit procedures.
- b. Cost-benefit of gathering evidence.
- c. Selected audit techniques.
- d. Financial statement assertions.

B.7. Timing of Audit Procedures

81. With respect to planning an audit, which of the following statements is **always** true?

- a. It is acceptable to perform a portion of the audit of a continuing audit client at interim dates.
- b. An engagement should not be accepted after the client's year-end.
- c. An inventory count must be observed at year-end.
- d. Final staffing decisions must be made prior to completion of the planning stage.

82. The element of the audit planning process **most** likely to be agreed upon with the client before implementation of the audit strategy is the determination of the

- a. Evidence to be gathered to provide a sufficient basis for the auditor's opinion.
- b. Procedures to be undertaken to discover litigation, claims, and assessments.
- c. Pending legal matters to be included in the inquiry of the client's attorney.
- d. Timing of inventory observation procedures to be performed.

C. Obtain an Understanding of the Entity and Its Environment

83. To obtain an understanding of a continuing client's business, an auditor **most** likely would

- a. Perform tests of details of transactions and balances.
- b. Review prior year working papers and the permanent file for the client.
- c. Read current issues of specialized industry journals.
- d. Reevaluate the client's internal control environment.

84. On an audit engagement performed by a CPA firm with one office, at the minimum, knowledge of the relevant professional accounting and auditing standards should be held by

- a. The auditor with final responsibility for the audit.
- b. All professionals working upon the audit.
- c. All professionals working upon the audit and the partner in charge of the CPA firm.
- d. All professionals working in the office.

85. An auditor obtains knowledge about a new client's business and its industry to

- a. Make constructive suggestions concerning improvements to the client's internal control.
- b. Develop an attitude of professional skepticism concerning management's financial statement assertions.
- c. Evaluate whether the aggregation of known misstatements causes the financial statements taken as a whole to be materially misstated.
- d. Understand the events and transactions that may have an effect on the client's financial statements.

86. Which of the following procedures would an auditor **least** likely perform while obtaining an understanding of a client in a financial statement audit?

- Coordinating the assistance of entity personnel in data preparation.
- Discussing matters that may affect the audit with firm personnel responsible for nonaudit services to the entity.
- Selecting a sample of vendors' invoices for comparison to receiving reports.
- Reading the current year's interim financial statements.

C.1. Communicate with Predecessor Auditors

87. Ordinarily, the predecessor auditor permits the successor auditor to review the predecessor's working paper analyses relating to

	Contingencies	Balance sheet accounts
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

88. In auditing the financial statements of Star Corp., Land discovered information leading Land to believe that Star's prior year's financial statements, which were audited by Tell, require substantial revisions. Under these circumstances, Land should

- Notify Star's audit committee and stockholders that the prior year's financial statements cannot be relied on.
- Request Star to reissue the prior year's financial statements with the appropriate revisions.
- Notify Tell about the information and make inquiries about the integrity of Star's management.
- Request Star to arrange a meeting among the three parties to resolve the matter.

89. A successor auditor should request the new client to authorize the predecessor auditor to allow a review of the predecessor's

	Engagement letter	Working papers
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

C.2. Consideration of Internal Control

90. Which of the following procedures would an auditor **most** likely perform in planning a financial statement audit?

- Inquiring of the client's legal counsel concerning pending litigation.
- Comparing the financial statements to anticipated results.

- Examining computer generated exception reports to verify the effectiveness of internal control.
- Searching for unauthorized transactions that may aid in detecting unrecorded liabilities.

C.3. Supervision Requirements

91. The in-charge auditor **most** likely would have a supervisory responsibility to explain to the staff assistants

- That immaterial fraud is not to be reported to the client's audit committee.
- How the results of various auditing procedures performed by the assistants should be evaluated.
- What benefits may be attained by the assistants' adherence to established time budgets.
- Why certain documents are being transferred from the current file to the permanent file.

92. The audit work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the

- Auditor's system of quality control has been maintained at a high level.
- Results are consistent with the conclusions to be presented in the auditor's report.
- Audit procedures performed are approved in the professional standards.
- Audit has been performed by persons having adequate technical training and proficiency as auditors.

C.4. Analytical Procedures

93. Analytical procedures used during risk assessment in an audit should focus on

- Reducing the scope of tests of controls and substantive tests.
- Providing assurance that potential material misstatements will be identified.
- Enhancing the auditor's understanding of the client's business.
- Assessing the adequacy of the available evidence.

94. A **primary** purpose of performing analytical procedures as risk assessment procedures is to identify the existence of

- Unusual transactions and events.
- Illegal acts that went undetected because of internal control weaknesses.
- Related-party transactions.
- Recorded transactions that were not properly authorized.

95. Which of the following nonfinancial information would an auditor **most** likely consider in performing analytical procedures during risk assessment?

- Turnover of personnel in the accounting department.
- Objectivity of audit committee members.
- Square footage of selling space.
- Management's plans to repurchase stock.

96. The accounts receivable turnover ratio increased during 20X2. This is consistent with:

- a. Items shipped on consignment during December were recorded as credit sales; no cash receipts have yet been received on these consignments.
- b. The company increased credit sales by 10% by allowing more lenient credit terms—30 days are now allowed whereas previously only 20 days were allowed.
- c. A major credit sale on which title passed as of December 31, 20X2 was recorded in January of 20X3.
- d. Sales for each month are approximately 25% higher than those of the preceding year.

97. A company's gross margin percentage increased in 20X2. This is consistent with which of the following occurring in 20X2?

- a. An increase in the tax rate on income.
- b. An increase in units sold.
- c. A decrease in the rate of sales commissions paid to sales personnel.
- d. Outsourcing of a part of the manufacturing process which resulted in no additional costs.

98. The following summarizes your client's inventory turnover for Years 1 and 2.

	Year 1	Year 2
Inventory turnover	7.00	6.00

This change is most consistent with

- a. A number of expense items were erroneously included in cost of goods sold (but not in ending inventory).
- b. While inventory levels remained the same in Year 2, total sales increased and a higher percentage of customers are paying their accounts.
- c. Although sales for Year 2 were the same as for Year 1, inventory is a bit higher than normal because the last month of year 2's sales were lower than anticipated.
- d. The year-end physical inventory count omitted a number of significant items. A periodic accounting inventory system is in use.

D.1. Assess the Risks of Material Misstatement and Design Further Audit Procedures—Overall Approach

99. While assessing the risks of material misstatement auditors identify risks, relate risk to what could go wrong, consider the magnitude of risks and

- a. Assess the risk of misstatements due to illegal acts.
- b. Consider the complexity of the transactions involved.
- c. Consider the likelihood that the risks could result in material misstatements.
- d. Determine materiality levels.

100. Which of the following are considered further audit procedures that may be designed after assessing the risks of material misstatement?

	Substantive tests of details	Risk assessment procedures
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

101. Which of the following is **least** likely to be considered a risk assessment procedure?

- a. Analytical procedures.
- b. Confirmation of ending accounts receivable.
- c. Inspection of documents.
- d. Observation of the performance of certain accounting procedures.

102. In an audit of a nonissuer (nonpublic) company, the auditors identify significant risks. These risks often

- a. Involve routine, high-volume transactions.
- b. Do not require special audit attention.
- c. Involve items with lower levels of inherent risk.
- d. Involve judgmental matters.

103. After fieldwork audit procedures are completed, a partner of the CPA firm who has not been involved in the audit performs a second or wrap-up working paper review. This second review usually focuses on

- a. The fair presentation of the financial statements in conformity with GAAP.
- b. Fraud involving the client's management and its employees.
- c. The materiality of the adjusting entries proposed by the audit staff.
- d. The communication of internal control weaknesses to the client's audit committee.

D.2. Using the Work of a Specialist

104. Which of the following statements is correct concerning an auditor's use of the work of a specialist?

- a. The work of a specialist who is related to the client may be acceptable under certain circumstances.
- b. If an auditor believes that the determinations made by a specialist are unreasonable, only a qualified opinion may be issued.
- c. If there is a material difference between a specialist's findings and the assertions in the financial statements, only an adverse opinion may be issued.
- d. An auditor may not use a specialist in the determination of physical characteristics relating to inventories.

105. In using the work of a specialist, an auditor may refer to the specialist in the auditor's report if, as a result of the specialist's findings, the auditor

- a. Becomes aware of conditions causing substantial doubt about the entity's ability to continue as a going concern.
- b. Desires to disclose the specialist's findings, which imply that a more thorough audit was performed.
- c. Is able to corroborate another specialist's earlier findings that were consistent with management's representations.
- d. Discovers significant deficiencies in the design of the entity's internal control that management does not correct.

106. Which of the following statements is correct about the auditor's use of the work of a specialist?

- a. The specialist should not have an understanding of the auditor's corroborative use of the specialist's findings.
- b. The auditor is required to perform substantive procedures to verify the specialist's assumptions and findings.
- c. The client should not have an understanding of the nature of the work to be performed by the specialist.
- d. The auditor should obtain an understanding of the methods and assumptions used by the specialist.

107. In using the work of a specialist, an auditor referred to the specialist's findings in the auditor's report. This would be an appropriate reporting practice if the

- a. Client is not familiar with the professional certification, personal reputation, or particular competence of the specialist.
- b. Auditor, as a result of the specialist's findings, adds an explanatory paragraph emphasizing a matter regarding the financial statements.
- c. Client understands the auditor's corroborative use of the specialist's findings in relation to the representations in the financial statements.
- d. Auditor, as a result of the specialist's findings, decides to indicate a division of responsibility with the specialist.

108. In using the work of a specialist, an understanding should exist among the auditor, the client, and the specialist as to the nature of the specialist's work. The documentation of this understanding should cover

- a. A statement that the specialist assumes no responsibility to update the specialist's report for future events or circumstances.
- b. The conditions under which a division of responsibility may be necessary.
- c. The specialist's understanding of the auditor's corroborative use of the specialist's findings.
- d. The auditor's disclaimer as to whether the specialist's findings corroborate the representations in the financial statements.

109. Which of the following is **not** a specialist upon whose work an auditor may rely?

- a. Actuary.
- b. Appraiser.
- c. Internal auditor.
- d. Engineer.

E. Required Communication to Those Charged with Governance

110. In identifying matters for communication with those charged with governance of an audit client, an auditor **most** likely would ask management whether

- a. The turnover in the accounting department was unusually high.
- b. It consulted with another CPA firm about accounting matters.
- c. There were any subsequent events of which the auditor was unaware.
- d. It agreed with the auditor's assessed level of control risk.

111. Which of the following statements is correct concerning an auditor's required communication with those charged with governance of an audit client?

- a. This communication is required to occur before the auditor's report on the financial statements is issued.
- b. This communication should include discussion of any significant disagreements with management concerning the financial statements.
- c. Any significant matter communicated to the audit committee also should be communicated to management.
- d. Significant audit adjustments proposed by the auditor and recorded by management need not be communicated to those charged with governance.

112. An auditor would **least** likely initiate a discussion with those charged with governance of an audit client concerning

- a. The methods used to account for significant unusual transactions.
- b. The maximum dollar amount of misstatements that could exist without causing the financial statements to be materially misstated.
- c. Indications of fraud and illegal acts committed by a corporate officer that were discovered by the auditor.
- d. Disagreements with management as to accounting principles that were resolved during the current year's audit.

113. Which of the following statements is correct about an auditor's required communication with those charged with governance of an audit client?

- a. Any matters communicated to the entity's audit committee also are required to be communicated to the entity's management.
- b. The auditor is required to inform those charged with governance about significant misstatements discovered by the auditor and subsequently corrected by management.

- c. Disagreements with management about the application of accounting principles are required to be communicated in writing to those charged with governance.
- d. Weaknesses in internal control previously reported to those charged with governance need not be recommunicated.

114. Which of the following matters is an auditor required to communicate to an entity’s audit committee?

- I. Disagreements with management about matters significant to the entity’s financial statements that have been satisfactorily resolved.
- II. Initial selection of significant accounting policies in emerging areas that lack authoritative guidance.

- a. I only.
- b. II only.
- c. Both I and II.
- d. Neither I nor II.

115. Should an auditor communicate the following matters to those charged with governance of an audit client?

	Significant audit adjustments recorded by the entity	Management’s consultation with other accountants about significant accounting matters
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

Multiple-Choice Answers and Explanations

Answers

1. a	—	—	21. a	—	—	41. a	—	—	61. c	—	—	81. a	—	—	100. b	—	—
2. d	—	—	22. d	—	—	42. b	—	—	62. b	—	—	82. d	—	—	101. b	—	—
3. b	—	—	23. b	—	—	43. d	—	—	63. d	—	—	83. b	—	—	102. d	—	—
4. b	—	—	24. c	—	—	44. b	—	—	64. a	—	—	84. a	—	—	103. a	—	—
5. a	—	—	25. b	—	—	45. a	—	—	65. b	—	—	85. d	—	—	104. a	—	—
6. c	—	—	26. d	—	—	46. a	—	—	66. b	—	—	86. c	—	—	105. a	—	—
7. c	—	—	27. c	—	—	47. a	—	—	67. a	—	—	87. a	—	—	106. d	—	—
8. b	—	—	28. a	—	—	48. c	—	—	68. c	—	—	88. d	—	—	107. b	—	—
9. b	—	—	29. a	—	—	49. b	—	—	69. d	—	—	89. c	—	—	108. c	—	—
10. b	—	—	30. c	—	—	50. d	—	—	70. c	—	—	90. b	—	—	109. c	—	—
11. b	—	—	31. d	—	—	51. d	—	—	71. a	—	—	91. b	—	—	110. b	—	—
12. d	—	—	32. d	—	—	52. d	—	—	72. c	—	—	92. b	—	—	111. b	—	—
13. a	—	—	33. b	—	—	53. c	—	—	73. b	—	—	93. c	—	—	112. b	—	—
14. c	—	—	34. d	—	—	54. b	—	—	74. c	—	—	94. a	—	—	113. b	—	—
15. b	—	—	35. c	—	—	55. a	—	—	75. a	—	—	95. c	—	—	114. a	—	—
16. b	—	—	36. c	—	—	56. c	—	—	76. b	—	—	96. c	—	—	115. a	—	—
17. a	—	—	37. d	—	—	57. b	—	—	77. c	—	—	97. b	—	—			
18. b	—	—	38. a	—	—	58. a	—	—	78. a	—	—	98. c	—	—			
19. a	—	—	39. a	—	—	59. b	—	—	79. d	—	—	99. c	—	—	1st: __/115 = __%		
20. b	—	—	40. a	—	—	60. b	—	—	80. d	—	—	100. b	—	—	2nd: __/115 = __%		

Explanations

1. (a) The requirement is to identify the categories of financial statement assertions. Answer (a) is correct because the professional standards establish financial statement assertions for account balances, classes of transactions and disclosures. Answer (b) is incorrect because financial statement assertions are established for disclosures. Answer (c) is incorrect because financial statement assertions are established for classes of transactions. Answer (d) is incorrect because financial statement assertions are established for both classes of transactions and disclosures.

2. (d) The requirement is to identify the item that is **not** a financial statement assertion relating to account balances. Answer (d) is correct because valuation and allocation is an account balance assertion, not valuation and *competence*. Answer (a) is incorrect because completeness is an assertion relating to account balances. Answer (b) is incorrect because existence is an assertion relating to account balances. Answer

(c) is incorrect because rights and obligations is an assertion relating to account balances.

3. (b) The requirement is to determine a likely auditor reaction to a decreased acceptable level of detection risk. Answer (b) is correct because postponement of interim substantive tests to year-end decreases detection risk by reducing the risk for the period subsequent to the performance of those tests; other approaches to decreasing detection risk include changing to more effective substantive tests and increasing their extent. Answer (a) is incorrect because increased, not reduced, substantive testing is required. Answer (c) is incorrect because inherent risk must be considered in planning, either by itself or in combination with control risk. Answer (d) is incorrect because tests of controls must be performed to reduce the assessed level of control risk.

4. (b) The requirement is to identify the risk that an auditor will conclude, based on substantive tests, that a material error does **not** exist in an account balance when, in fact, such error

does exist. Answer (b) is correct because detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk may be viewed in terms of two components (1) the risk that analytical procedures and other relevant substantive tests would fail to detect misstatements equal to tolerable misstatement, and (2) the allowable risk of incorrect acceptance for the substantive tests of details. Answer (a) is incorrect because sampling risk arises from the possibility that, when a test of controls or a substantive test is restricted to a sample, the auditor's conclusions may be different from the conclusions he or she would reach if the tests were applied in the same way to all items in the account balance or class of transactions. When related to substantive tests sampling risk is only a part of the risk that the auditor's substantive tests will not detect a material misstatement. Answer (c) is incorrect because nonsampling risk includes only those aspects of audit risk that are not due to sampling. Answer (d) is incorrect because inherent risk is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls.

5. (a) The requirement is to identify an effect of a decrease in the acceptable level of detection risk. Answer (a) is correct because as the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase. To gain this increased assurance the auditors may (1) change the nature of substantive tests to more effective procedures (e.g., use independent parties outside the entity rather than those within the entity), (2) change the timing of substantive tests (e.g., perform them at year-end rather than at an interim date), and (3) change the extent of substantive tests (e.g., take a larger sample). Answer (b) is incorrect because the assurance provided from substantive tests increases, it does not decrease. Answers (c) and (d) are incorrect because the acceptable level of detection risk is based largely on the assessed levels of control risk and inherent risk. Accordingly, any tests of controls will already have been performed.

6. (c) The requirement is to determine whether inherent risk, control risk, and detection risk may be assessed in nonquantitative terms. Answer (c) is correct because all of these risks may be assessed in either quantitative terms such as percentages, or nonquantitative terms such as a range from a minimum to a maximum.

7. (c) The requirement is to determine a manner in which inherent risk and control risk differ from detection risk. Answer (c) is correct because inherent risk and control risk exist independently of the audit of the financial statements as functions of the client and its environment, whereas detection risk relates to the auditor's procedures and can be changed at his or her discretion. Answer (a) is incorrect because inherent risk and control risk are functions of the client and its environment and do not arise from misapplication of auditing procedures. Answer (b) is incorrect because inherent risk, control risk and detection risk may each be assessed in either quantitative or nonquantitative terms. Answer (d) is incorrect because inherent risk and control risk are functions of the client and its environment, they cannot be changed at the auditor's discretion. However, the assessed levels of inherent and control risk (not addressed in this question) may be

affected by auditor decisions relating to the cost of gathering evidence to substantiate assessed levels below the maximum.

8. (b) The requirement is to determine the **best** way for an auditor to achieve an overall audit risk level when the audit evidence relating to control risk indicates the need to increase its assessed level. Answer (b) is correct because a decrease in detection risk will allow the auditor achieve an overall audit risk level substantially the same as planned. Answer (a) is incorrect because a decrease in substantive testing will increase, not decrease, detection risk and thereby increase audit risk. Answer (c) is incorrect because an increase in inherent risk will also increase audit risk. Answer (d) is incorrect because there appears to be no justification for increasing materiality levels beyond those used in planning the audit.

9. (b) The requirement is to determine the relationship between control risk and detection risk. Inverse is correct because as control risk increases (decreases) detection risk must decrease (increase).

10. (b) The requirement is to identify the information that an auditor would **most** likely use in determining a preliminary judgment about materiality. Answer (b) is correct because many materiality measures relate to an annual figure (e.g., net income, sales). Answer (a) is incorrect because the preliminary judgment about materiality is a factor used in determining the anticipated sample size, not the reverse as suggested by the reply. Answers (c) and (d) are incorrect because materiality will not normally be affected by the results of the internal control questionnaire or the contents of the management representation letters.

11. (b) The requirement is to identify the statement that is **not** correct concerning materiality. Answer (b) is the proper reply because the auditor considers materiality for planning purposes in terms of the smallest, not the largest, aggregate amount of misstatement that could be material to any one of the financial statements. Answers (a), (c), and (d) all represent correct statements about materiality.

12. (d) The requirement is to identify which reply is a function of the risks of material misstatement and detection risk. Answer (d) is correct because audit risk is the risk that auditor expresses an inappropriate audit opinion when the financial statements are misstated, and it is a function of the risks of material misstatement and detection risk. Answer (a) is incorrect because while a consideration of internal control is required during an audit, internal control is not a function of these risks. Answer (b) is incorrect because while corroborating evidence is obtained to measure these risks, it is not a function of them. Answer (c) is incorrect because quality control relates to requirements placed upon the CPAs while conducting an audit.

13. (a) The requirement is to determine the correct statement with respect to performance materiality on an audit. Answer (a) is correct because performance materiality is largely established to help provide assurance that several immaterial misstatements do not combine to a material undetected amount of misstatement; accordingly, it ordinarily is established at a level lower than that of materiality for the financial statements.

Answer (b) is incorrect because performance materiality may be revised throughout the audit, particularly when circumstances depart from those which had been expected while planning the audit. Answer (c) is incorrect because performance materiality is ordinarily established for the financial statements as a whole, and if applicable, materiality levels for particular classes of transactions, account balances, or disclosures. Answer (d) is incorrect because performance materiality must be documented in the working papers.

14. (c) The requirement is to identify the information that an auditor would be **most** likely to use in making a preliminary judgment about materiality. Answer (c) is correct because auditors often choose to use a measure relating to the prior year's financial statements (e.g., a percentage of total assets, net income, or revenue) to arrive at a preliminary judgment about materiality. Answer (a) is incorrect because materiality is based on the magnitude of an omission or misstatement and not on the initial assessment of control risk. Answer (b) is incorrect because while an auditor's materiality judgment will affect the anticipated sample size for planned substantive tests, sample size does not affect the materiality judgment. Answer (d) is incorrect because the assertions embodied in the financial statements remain the same from one audit to another.

15. (b) The requirement is to identify the **most** likely effect of a decrease in the tolerable amount of misstatement (tolerable misstatement) in a class of transactions. Answer (b) is correct because auditing standards state that decreasing the tolerable amount of misstatement will require the auditor to do one or more of the following: (1) perform auditing procedures closer to the balance sheet date (answer [b]); (2) select a more effective auditing procedure; or (3) increase the extent of a particular auditing procedure. Answer (a) is incorrect because in such a circumstance substantive tests are more likely to be performed at or after the balance sheet date than prior to the balance sheet date. Answer (c) is incorrect because decreasing the tolerable amount of misstatement will not necessarily lead to an increase in the assessed level of control risk. Answer (d) is incorrect because the extent of auditing procedures will be increased, not decreased.

16. (b) The requirement is to identify the necessary condition for an auditor to be able to issue an unmodified opinion. Answer (b) is correct because if the estimate of likely misstatement is equal to or greater than a material amount a material departure from generally accepted accounting principles exists and thus AU-C 705 requires either a qualified or adverse opinion in such circumstances. Answer (a) is incorrect because the amount of known misstatement (if any) need not be documented in the management representation letter. Answer (c) is incorrect because it ordinarily is not necessary for the client to acknowledge and record immaterial known misstatements. Answer (d) is incorrect because the total likely misstatement need not include the adjusting entries already recorded by the client.

17. (a) The requirement is to identify the example of fraudulent financial reporting. Answer (a) is correct because fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in

financial statements to deceive financial statement users and changing the inventory count tags results in such a misstatement. Answers (b), (c), and (d) are all incorrect because they represent the misappropriation of assets. See AU-C 240, which divides fraudulent activities into misstatement arising from fraudulent financial reporting and misstatements arising from misappropriation of assets (sometimes referred to as defalcation).

18. (b) The requirement is to identify the **best** description of what is meant by a "fraud risk factor." Answer (b) is correct because AU-C 240 suggests that while fraud risk factors do not necessarily indicate the existence of fraud, they often have been observed in circumstances where frauds have occurred. Answer (a) is incorrect because the risk of fraud may or may not be high when a risk factor is present. Answer (c) is incorrect because the current audit plan may in many circumstances appropriately address a fraud risk factor. Answer (d) is incorrect because a fraud risk factor may or may not represent a material weakness.

19. (a) The requirement is to identify the reply which represents an auditor communication responsibility relating to fraud. Answer (a) is correct because all fraud involving senior management should be reported directly to the audit committee. Answer (b) is incorrect because auditors are only required to report fraud to the Securities and Exchange Commission under particular circumstances. Answer (c) is incorrect because auditors do not ordinarily disclose fraud through use of an "emphasis of a matter" paragraph added to their report. Answer (d) is incorrect because under certain circumstances auditors must disclose fraud outside the entity.

20. (b) The requirement is to identify the risk relating to material misstatement that auditors are required to assess. Answer (b) is correct because auditors must specifically assess the risk of material misstatements due to fraud and consider that assessment in designing the audit procedures to be performed. Answer (a) is incorrect because while AU-C 315 also requires an assessment of the overall risk of material misstatement (whether caused by error or fraud) there is no requirement to explicitly assess the risk of material misstatement due to errors. Answer (c) is incorrect because the auditor need not explicitly assess the risk of misstatement due to illegal acts. Answer (d) is incorrect because no assessment of business risk is required.

21. (a) The requirement is to determine whether audits are designed to provide reasonable assurance of detecting misstatements due to errors, fraudulent financial reporting, and/or misappropriation of assets. Answer (a) is correct because AU-C 240 requires that an audit obtain reasonable assurance that material misstatements, whether caused by error or fraud, be detected. Fraudulent financial reporting and the misappropriation of assets are the two major types of fraud with which an audit is relevant.

22. (d) The requirement is to identify the reply which is **not** a reason why auditors are unable to obtain absolute assurance that misstatements due to fraud will be detected. Answer (d) is correct because while an auditor must exercise professional skepticism when performing an audit it does not represent

a limitation that makes it impossible to obtain absolute assurance. Answers (a), (b), and (c) are all incorrect because they represent factors considered in the professional literature for providing reasonable, and not absolute assurance.

23. (b) The requirement is to determine which concept requires an attitude that includes a questioning mind and a critical assessment of audit evidence. Answer (b) is correct because AU-C 200 states that professional skepticism includes these qualities. Answer (a) is incorrect because due professional care is a broader concept that concerns what the independent auditor does and how well he or she does it. Answer (c) is incorrect because reasonable assurance is based on the concept that an auditor is not an insurer and his or her report does not provide absolute assurance. Answer (d) is incorrect because supervision involves the directing of the efforts of assistants who are involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished.

24. (c) The requirement is to determine what presumption concerning management's honesty that professional skepticism requires. Answer (c) is correct because professional skepticism requires that an auditor neither assume dishonesty nor unquestioned honesty. Answers (a) and (b) are incorrect because neither honesty in the absence of fraud risk factor nor dishonesty are assumed. Answer (d) is incorrect because the concept of reasonable assurance is not directed towards management's honesty.

25. (b) The requirement is to identify the type of fraudulent misstatement that is most difficult to detect. Answer (b) is correct because transactions that have not been recorded are generally considered most difficult because there is no general starting point for the auditor in the consideration of the transaction. Answers (a), (c), and (d) all represent recorded transactions which, when audited, are in general easier to detect.

26. (d) The requirement is to identify the **least** likely indicator of a risk of possible misstatement due to fraud. Answer (d) is correct because one would expect unusually aggressive, rather than unusually conservative accounting practices to indicate a risk of misstatement due to fraud. Answers (a), (b), and (c) are all incorrect because they represent risk factors explicitly included in AU-C 240, which provides guidance on fraud.

27. (c) The requirement is to determine the reply which represents information **most** likely to affect the auditor's assessment of the risk of misstatement due to fraud. Answer (c) is correct because AU-C 240 states that missing documents may be indicative of fraud. Answer (a) is incorrect because checks for significant amounts are normally expected to be outstanding at year-end. Answer (b) is incorrect because almost all audits involve computer generated documents and their existence is not considered a condition indicating possible fraud. Answer (d) is incorrect because while last-minute adjustments that significantly affect financial results may be considered indicative of possible fraud, year-end adjusting journal entries alone are to be expected.

28. (a) The requirement is to identify the **most** likely response to the auditor's assessment that the risk of material misstatement due to fraud for the existence of inventory is high. Answer (a) is correct because observing test counts of inventory on an unannounced basis will provide evidence as to whether record inventory exists. Answer (b) is incorrect because replacing test counts with analytical procedures is not likely to be particularly effective. Answers (c) and (d) are incorrect because the inventories might well be counted at year-end, all on the same date, rather than prior to year-end and at differing dates.

29. (a) The requirement is to identify the reply that is **most** likely to be an example of fraud. Answer (a) is most likely, since "defalcation" is another term for misstatements arising from misappropriation of assets, a major type of fraud. Answers (b), (c), and (d) are all incorrect because mistakes in the application of accounting principles or in processing data, and unreasonable accounting estimates arising from oversight are examples of misstatements rather than fraud.

30. (c) The requirement is to identify the characteristic **most** likely to heighten an auditor's concern about the risk of intentional manipulation of financial statements. Answer (c) is correct because the placement of substantial emphasis on meeting earnings projections is considered a risk factor. Answer (a) is incorrect because high turnover, not low turnover, is considered a risk factor. Answer (b) is incorrect because insider purchases of additional shares of stock are less likely to be indicative of intentional manipulation of the financial statements than is undue emphasis on meeting earnings projections. Answer (d) is incorrect because a rapid rate of change in an industry, not a slow rate, is considered a risk factor.

31. (d) The requirement is to identify an auditor's responsibility for detecting errors and fraud. Answer (d) is correct because AU-C 200 requires that an auditor design the audit to provide reasonable assurance of detecting misstatements due to errors and fraud that are material to the financial statements. Answer (a) is incorrect because audits provide reasonable assurance of detecting material errors and fraud. Answer (b) is incorrect because it doesn't restrict the responsibility to material errors and fraud. Answer (c) is incorrect because it is less precise than answer (d), which includes the AU-C 200 responsibility on errors and fraud.

32. (d) The requirement is to identify the circumstances in which an auditor may have a responsibility to disclose fraud to parties other than a client's senior management and its audit committee or board of directors. Answer (d) is correct because AU-C 240 states that such a responsibility may exist to the SEC when there has been an auditor change to a successor auditor or to comply with SEC 1995 Private Securities Reform Act communication requirement, when the successor auditor makes inquiries, and to a government agency from which the client receives financial assistance. In addition, that section states that an auditor may have such a disclosure responsibility in response to a subpoena, a circumstance not considered in this question.

33. (b) Errors refer to unintentional mistakes in financial statements such as misinterpretation of facts. Answers (a), (c),

and (d) all represent fraud which are defined as intentional distortions of financial statements.

34. (d) The requirement is to identify the level of assurance an auditor provides with respect to detection of material errors, fraud, and direct effect illegal acts. Answer (d) is correct because AU-C 200 requires the auditor to design the audit to provide reasonable assurance of detecting material errors, fraud and direct effect illegal acts. (A “direct effect” illegal act is one that would have an effect on the determination of financial statement amounts.)

35. (c) The requirement is to identify the proper attitude of an auditor who is performing an audit in accordance with generally accepted auditing standards. Answer (c) is correct because the auditor should plan and perform the audit with an attitude of professional skepticism, recognizing that the application of the auditing procedures may produce evidence indicating the possibility of misstatements due to errors or fraud. Answer (a) is incorrect because while the CPA must exhibit objective judgment, “professional skepticism” more accurately summarizes the proper attitude during an audit. Answer (b) is incorrect because while a CPA must be independent and have integrity, this is not the “attitude” used to plan and perform the audit. Answer (d) is incorrect because the audit is not planned and performed with impartial conservatism.

36. (c) The requirement is to identify the meaning of the term “material misstatement” when used in the professional standards. Answer (c) is correct because AU-C 240 states that a material misstatement may occur due to errors, fraud, and illegal acts with a direct effect on financial statement amounts.

37. (d) The requirement is to identify an auditor’s responsibility for detecting financial stress of employees or adverse relationships between a company and its employees. Answer (d) is correct because AU-C 240 states that, while the auditor is not required to plan the audit to discover information that is indicative of financial stress of employees or adverse relationships between the company and its employees, such conditions must be considered when an auditor becomes aware of them. Answers (a), (b), and (c) are all incorrect because the auditor does not plan the audit to detect these conditions.

38. (a) The requirement is to identify an auditor’s responsibility when he or she believes that a misstatement is or may be the result of fraud, but that the effect of the misstatements is immaterial to the financial statements. Answer (a) is correct because AU-C 240 states that in such circumstances the auditor should evaluate the implications of the fraud, especially those dealing with the organizational position of the person(s) involved.

39. (a) The requirement is to identify the correct statements relating to the auditor’s consideration of fraud. Answer (a) is correct because AU-C 240 states that the auditor’s interest relates to fraudulent acts that cause a material misstatement of financial statements. Answer (b) is incorrect because errors are unintentional. Answer (c) is incorrect because fraud does not necessarily involve the misappropriation of assets (it may involve fraudulent financial reporting). Answer (d) is incorrect because an auditor must design an audit to obtain reasonable

assurance of detecting misstatements, regardless of whether they are caused by errors or fraud.

40. (a) The requirement is to identify the factor or condition that an audit is **least** likely to be planned to discover. Answer (a) is correct because it represents a financial stress, and auditors are not required to plan audits to discover information that is indicative of financial stress of employees or adverse relationships between the entity and its employees. Answers (b), (c), and (d) are all incorrect because they represent examples of risk factors that should be considered in an audit and are included in AU-C 240.

41. (a) The requirement is to determine when audit risk factors may be identified. Answer (a) is correct because AU-C 240 states that fraud risk factors may be identified during planning, obtaining an understanding, or while conducting fieldwork; in addition, they may be identified while considering acceptance or continuance of clients and engagements.

42. (b) The requirement is to identify the circumstance in which it is **most** likely that management’s attitude toward aggressive financial reporting and toward meeting projected profit goals would most likely significantly influence an entity’s control environment. Answer (b) is correct because when management is dominated by one individual, that individual may be able to follow overly aggressive accounting principles.

43. (d) The requirement is to identify the procedure **least** likely to be required on an audit. Answer (d) is correct because fraud is a broad legal concept and auditors do not make legal determinations of whether fraud has occurred. Answers (a), (b), and (c) are incorrect because considering journal entries, estimates, and unusual transactions are ordinarily required audit procedures to address the risk of management override of controls. See AU-C 240 for information on the auditor’s responsibility for the consideration of fraud in a financial statement audit.

44. (b) The requirement is to identify the **most** likely response when a risk of fraud has been identified on an audit. Answer (b) is correct because AU-C 240 indicates that overall responses to the risk of material misstatements due to fraud include (1) assigning personnel with particular skills relating to the area and considering the necessary extent of supervision to the audit, (2) increasing the consideration of management’s selection and application of accounting principles, and (3) making audit procedures less predictable. Answer (a) is incorrect because closer supervision, not less close supervision, is more likely to be appropriate. Answer (c) is incorrect because individuals with specialized skills may be needed who are not CPAs. Answer (d) is incorrect because subjective transactions (e.g., accounting estimates) often provide more risk than objective transactions.

45. (a) The requirement is to identify the **least** likely inquiry of management relating to identifying the risk of material misstatement due to fraud. Answer (a) is correct because financial operations of many companies are not ordinarily controlled by and limited to one location. Answers (b), (c), and

(d) are all incorrect because they are included in AU-C 240 as inquiries that should be made of management.

46. (a) The requirement is to identify the attributes ordinarily present when individuals commit fraud. Answer (a) is correct because AU-C 240 suggests that the three conditions generally present when fraud occurs are that individuals have an (1) incentive or pressure, (2) opportunity, and (3) ability to rationalize. Answers (b), (c), and (d) are all incorrect because they suggest that one of the three elements is not ordinarily present.

47. (a) The requirement is to determine an auditor's reporting responsibility when he or she has discovered that management is involved in a financially immaterial fraud. Answer (a) is correct because AU-C 240 requires that all management fraud, regardless of materiality, be reported to the audit committee. Answer (b) is incorrect because fraud is not directly reported to the Public Company Accounting Oversight Board. Answer (c) is incorrect because if anything, in addition to the audit committee, the fraud is reported to a level of management at least one level above those involved in a fraud. Answer (d) is incorrect because there is a reporting responsibility for financially immaterial management fraud.

48. (c) The requirement is to identify the **most** likely risk factor relating to fraudulent financial reporting. Answer (c) is correct because negative cash flows from operations may result in pressure upon management to overstate the results of operations. Answer (a) is incorrect because one would expect a company's top executives to dominate management—domination by one or a few might be considered a risk factor. Answers (b) and (d) are incorrect because large amounts of cash being processed and small high-dollar inventory items are more directly related to the misappropriation of assets than they are to fraudulent financial reporting.

49. (b) The requirement is to identify the **most** likely fraud risk factor on an audit. Answer (b) is correct because the possibility of improper revenue recognition is ordinarily presumed on audits. Answers (a), (c), and (d) all represent potential risks, but risks that are not ordinarily presumed on an audit. See AU-C 240 for information on the auditor's responsibility for the consideration of fraud in a financial statement audit.

50. (d) The requirement is to identify the circumstances relating to the discovery of the payment of small bribes to municipal officials that is **most** likely to cause an auditor to withdraw from an engagement. Answer (d) is correct because AU-C 250 states that management failure to take the appropriate remedial action is particularly problematical since it may affect the auditor's ability to rely on management representation and may therefore lead to withdrawal. Answers (a), (b), and (c) all represent circumstances which the auditor will consider, but are not ordinarily considered as serious as failure to take the appropriate remedial action.

51. (d) The requirement is to identify the factor **most** likely to cause a CPA **not** to accept a new audit engagement. Answer (d) is correct because a part of the understanding an auditor must obtain with a client is that management is responsible for making all financial records and related information available.

Accordingly, if the client refuses to make such information available the auditor is unlikely to accept the audit client. Answer (a) is incorrect because a circumstance-imposed scope limitations such as completion of the physical inventory count results in a situation in which the auditor may consider using alternative procedures (including making some test counts) to determine whether inventory counts are proper. Answer (b) is incorrect because an auditor may obtain an understanding of the client's operations and industry while performing the audit. Answer (c) is incorrect because while a review of the predecessor auditor's working papers is ordinarily desirable, it is not required.

52. (d) The requirement is to identify the factor **most** likely to heighten an auditor's concern about the risk of fraudulent financial reporting. Answer (d) is correct because AU-C 240, which presents a variety of risk factors, suggests that an overly complex organizational structure is such a risk factor. Answer (a) is incorrect because large amounts of liquid assets that are easily convertible into cash represent more of a risk relating to misappropriation of assets rather than to fraudulent financial reporting. Answer (b) is incorrect because high growth, rather than low growth, is considered a risk factor. Answer (c) is incorrect because one would expect financial management's participation in the initial selection of accounting principles.

53. (c) The requirement is to identify the situation in which an auditor would be **most** likely to withdraw from an engagement when he or she has discovered that a client's employees have paid small bribes to public officials. Answer (c) is correct because AU-C 250 states that resignation should be considered when an illegal act does not receive proper remedial action, because such inaction may affect the auditor's ability to rely on management representations and the effects of continued association with the client. Answer (a) is incorrect because the receipt of federal funds in such a situation is not as likely to result in auditor withdrawal as is answer (c). Answer (b) is incorrect because it seems inconsistent with the premise of the question in that, if no evidence exists, the auditor is unlikely to know that bribes have been paid. Answer (d) is incorrect because such small bribes will not ordinarily need to be disclosed. Alternatively, if the auditor believes that there is such a need, the lack of such disclosure represents a departure from generally accepted accounting principles and either a qualified or adverse opinion is appropriate.

54. (b) The requirement is to identify the illegal act that an audit should be designed to obtain reasonable assurance of detecting. Answer (b) is correct because the accrual and billing of an improper amount of revenue under government contracts is an illegal act with a direct effect on the determination of financial statement amounts, and audits are designed to detect such illegal acts. Answers (a), (c), and (d) are all incorrect because they represent illegal acts with an indirect financial statement effect and an audit provides no assurance that such acts will be detected or that any contingent liabilities that may result will be disclosed. See AU-C 250 for detailed guidance on auditor responsibility with respect to direct and indirect illegal acts.

55. (a) The requirement is to identify the small misstatement that is **most** likely to have a material effect on an

entity's financial statements. Answer (a) is correct because an illegal payment of an otherwise immaterial amount may be material if there is a reasonable possibility that it may lead to a material contingent liability or a material loss of revenue.

56. (c) The requirement is to determine what an auditor might reconsider when a client's board of directors has refused to take any action relating to an auditor's disclosure that the company has made immaterial illegal contributions. Answer (c) is correct because in such a circumstance the failure to take remedial action may cause an auditor to decrease reliance on management representations. Answer (a) is incorrect because the reply by the attorney is likely to disclose any claims, litigation or assessments that the client has improperly omitted from the letter of audit inquiry. Answer (b) is incorrect because the prior years' audit plans are not being relied upon for this year's audit. Answer (d) is incorrect because the preliminary judgment about materiality levels would not be expected to change.

57. (b) The requirement is to identify a reason why audits **cannot** reasonably be expected to bring all illegal acts to the auditor's attention. Answer (b) is correct because illegal acts relating to the operating aspects of an entity are often highly specialized and complex and often are far removed from the events and transactions reflected in financial statements. Answer (a) is partially correct since management override represents a limitation of the effectiveness of internal control. Yet, auditors are more likely to identify such transactions because they relate to events and transactions reflected in the financial statements. Answer (c) is incorrect because many illegal acts are not subject to the client's internal control. Answer (d) is incorrect because illegal acts may be perpetrated without access to both assets and accounting records.

58. (a) The requirement is to determine an auditor's responsibility when information comes to his/her attention that implies the existence of possible illegal acts with a material, but indirect effect on the financial statements. Answer (a) is correct because AU-C 250 requires the auditor to apply audit procedures specifically designed to determine whether an illegal act has occurred when such information comes to his/her attention. Answers (b), (c), and (d) are all incorrect because they represent procedures the auditor would perform after initial procedures had confirmed the existence of the possible illegal act(s).

59. (b) The requirement is to determine the circumstance in which it is **most** likely that a CPA would withdraw from an audit engagement after having discovered that client employees have committed an illegal act. Answer (b) is correct because the auditor may conclude that withdrawal is necessary when the client does not take the remedial action, even when the illegal act is not material to the financial statements. Answers (a) and (c) are incorrect because whether generally accepted accounting principles have been violated and whether the illegal act occurred during a prior year that was not audited may or may not have an effect on the decision to withdraw from the engagement. Answer (d) is incorrect because the assessed level of control risk will not have a direct relationship on the decision to withdraw from the engagement.

60. (b) The requirement is to identify a CPA's responsibility under the Securities Litigation Reform Act of 1995 for uncorrected illegal acts which have been communicated to the board of directors which refuses to inform the SEC of their existence. Answer (b) is correct because CPAs are required under the law to deliver a report on those illegal acts to the SEC within one business day in such circumstances. Answer (a) is incorrect because there is no requirement to resign, although the auditor may decide to do so. Answer (c) is incorrect because the Act sets up reporting to the SEC, not to the stockholders. Answer (d) is incorrect because withholding of the audit opinion is not suggested in the Act.

61. (c) The requirement is to identify the procedure **least** likely to be considered an audit planning procedure. Answer (c) is correct because performing the risk assessment occurs subsequent to audit planning. Answer (a) is incorrect because an engagement letter is used to establish an understanding with the client, and this is a planning procedure. Answer (b) is incorrect because auditors develop the overall audit strategy during audit planning. Answer (d) is incorrect because the audit plan is developed during planning.

62. (b) The requirement is to identify the factor **most** likely to cause a CPA to decide **not** to accept a new audit engagement. Answer (b) is correct because a certain level of internal control is essential for financial statement reporting, and management's disregard in this area may lead the CPA to reject the engagement. Answer (a) is incorrect both because a CPA may not need an understanding of the prospective client's internal auditor's computer-assisted audit technique to form an opinion on the financial statements, and because if such understanding is necessary, it can be obtained subsequent to engagement acceptance. Answer (c) is incorrect because AU-C 550 indicates that a CPA often will be unable to determine whether related-party transactions were consummated on terms equivalent to arm's-length transactions. Answer (d) is incorrect because while management's refusal to permit the performance of substantive tests before the year-end may present a problem, the auditor may be able to effectively perform such tests after year-end.

63. (d) The requirement is to identify a requirement prior to accepting an engagement to audit a new client. Answer (d) is correct because AU-C 210 requires that an auditor attempt to obtain client permission to contact the predecessor prior to accepting a new engagement. Answers (a), (b), and (c) are incorrect because they may all be obtained subsequent to accepting an engagement.

64. (a) The requirement is to determine the nature of the inquiries that a successor auditor should make of the predecessor auditor prior to accepting an audit engagement. Answer (a) is correct because the inquiries should include specific questions to management on (1) disagreements with management as to auditing procedures and accounting principles (answer [a]), (2) facts that might bear on the integrity of management and (3) the predecessor's understanding as to the reasons for the change of auditors. Answers (b), (c), and (d) are incorrect because, if made at all, they will be after the engagement has been accepted.

65. (b) The requirement is to identify the correct statement regarding a successor auditor's inquiries of the predecessor auditor. Answer (b) is correct because the successor should request information such as (1) facts that might bear on the integrity of management, (2) disagreements with management as to accounting principles, auditing procedures, or other significant matters, and (3) the predecessor's understanding of the reasons for the change of auditors. Answers (a), (c), and (d) all relate to matters not required to be discussed prior to accepting an audit engagement.

66. (b) The requirement is to identify the item ordinarily included when an auditor establishes an understanding with a client regarding the services to be performed. Answer (b) is correct because auditing standards require that an auditor ensure that the audit committee is aware of any significant deficiencies which come to the CPA's attention. Answer (a) is incorrect because while an understanding will include a statement that management is responsible for the entity's financial statements, an explicit statement about errors and illegal activities of employees is not ordinarily included. Answer (c) is incorrect because management does not provide the auditor with an assessment of the risk of material misstatement due to fraud. Answer (d) is incorrect because no such statement about an auditor's responsibility for determining preliminary judgments about materiality and audit risk factors is ordinarily included in establishing an understanding. See AU-C 210 for information on establishing an understanding with a client.

67. (a) The requirement is to identify the matter generally included in an auditor's engagement letter. Answer (a) is correct because AU-C 210, which outlines requirements for engagement letters, indicates that an engagement letter should include an indication that management is responsible for identifying and ensuring that the company complies with the laws and regulations applicable to its activities. Answer (b) is incorrect because such detailed information on materiality is not generally included in an engagement letter. Answer (c) is incorrect because management liability (if any) for illegal acts committed by employees is not generally included in an engagement letter. Answer (d) is incorrect because while an auditor is required to obtain an understanding of internal control, he or she is not required to search for significant internal control deficiencies.

68. (c) The requirement is to identify the **most** likely procedure during the initial planning phase of an audit. Answer (c) is correct because during initial planning the timing of procedures will be discussed due to the need for client assistance with many of these procedures. Answer (a) is incorrect because the timing of audit procedures will occur subsequent to the initial planning stage of an audit. Answer (b) is incorrect because the evaluation of reasonableness of the client's accounting estimates will occur after planning—see AU-C 540. Answer (d) is incorrect because the inquiry of a client's attorney will occur subsequently to initial planning—see AU-C 501.

69. (d) The requirement is to identify the statement that is **least** likely to appear in an auditor's engagement letter. Answer (d) is correct because auditors ordinarily will not discuss

with management the details of procedures that are necessary to perform the audit. Answers (a), (b), and (c) are incorrect because engagement letters will include a statement on the risk of not detecting material errors and fraud, and may include information on fees and observed opportunities for economy.

70. (c) The requirement is to identify the item for which the generally accepted auditing standards do **not** require documentation. Answer (c) is correct because while a CPA firm will include an engagement letter in the working papers, it will not detail the auditor's planned fieldwork. Answer (a) is incorrect because SAS 300 requires a written audit plan. Answer (b) is incorrect because AU-C 230 requires that the working papers document the agreement or reconciliation of the accounting records with the financial statements. Answer (d) is incorrect because AU-C 315 requires the auditor to document the assessment of the risks of material misstatement.

71. (a) The requirement is to determine what types of items are ordinarily included in an engagement letter in addition to the objectives of the engagement. Answer (a) is correct because AU-C 210 also requires inclusion of information on CPA responsibilities, client responsibilities, and limitations of the engagement.

72. (c) The requirement is to determine the reply which is **least** likely to be included in an engagement letter. Answer (c) is correct because AU-C 210, which provides information on obtaining an understanding with the client, does not suggest any arrangement concerning CPA investment in client securities; indeed such investments are prohibited by the *Code of Professional Conduct*. Answers (a), (b), and (d) all represent arrangements which AU-C 210 suggests may be included in an engagement letter (or other form of understanding with a client).

73. (b) The requirement is to identify form(s) of documentation of the understanding obtained with a client. Answer (b) is correct because the professional standards require that an auditor document the understanding through a written communication with the client. Answer (a) is incorrect because an oral communication is not sufficient. Answer (c) is incorrect because the communication should be in writing. Answer (d) is incorrect because the understanding is not documented in a *completely detailed audit plan*—a term of questionable meaning.

74. (c) The requirement is to identify the factor that **most** likely would influence an auditor's determination of the auditability of an entity's financial statements. Answer (c) is correct because inadequate accounting records may cause an auditor to conclude that it is unlikely that sufficient appropriate evidence will be available to support an opinion on the financial statements; accordingly, an auditor may determine that the financial statements are not auditable. Answer (a) is incorrect because an auditor should be able to obtain the knowledge necessary to audit a complex accounting system. Answer (b) is incorrect because while related-party transactions may raise transaction valuation issues due to the lack of an "arm's-length transaction," the problem is normally not so severe as to make the entity not auditable. Answer (d) is incorrect because a lack of operating effectiveness of controls may often be overcome through an increase in the scope of substantive tests.

75. (a) The requirement is to identify the area that is **most** likely to require special audit planning considerations. Answer (a) is correct because an inventory comprised of diamond rings is likely to require that the auditor plan ahead to involve a specialist to assist in valuation issues. Answer (b) is incorrect because valuation of an asset such as a new copy machine is not ordinarily expected to provide valuation difficulties. Answer (c) is incorrect because the expensing purchases of such small assets is ordinarily acceptable due to the immateriality of the transactions. Answer (d) is incorrect because accelerated depreciation methods are ordinarily acceptable.

76. (b) The requirement is to identify the information source that a CPA would **most** likely consult for information on how various publicly held companies have complied with the disclosure requirements of a new financial accounting standard. Answer (b) is correct because AICPA *Accounting Trends and Techniques*, which is issued annually, summarizes such disclosures of 600 industrial and merchandising corporations. Answer (a) is incorrect because the AICPA *Codification of Statements on Auditing Standards* codifies the various Statements on Auditing Standards and does not include information on individual company compliance with disclosure requirements. Answer (c) is incorrect because Quality Control Review standards are established by the AICPA and because they do not include information on individual company compliance with disclosure requirements. Answer (d) is incorrect because Form 10-K itself provides information on preparing Form 10-K and this form does not include information on individual company compliance with disclosure requirements.

77. (c) The requirement is to determine the correct statement regarding to an audit plan. Answer (c) is correct because an audit plan sets forth in detail the audit procedures that are necessary to accomplish the objectives of the audit. Answer (a) is incorrect because audit plans address topics beyond selecting material transactions and this is not their primary focus. Answer (b) is incorrect because a program may include numerous substantive tests to be performed prior to the balance sheet date. Answer (d) is incorrect because immaterial accounts often are not tested and because tests of transactions, tests of balances, and analytical procedures are used to test account balances; account balances are not directly tested through tests of controls.

78. (a) The requirement is to determine the situation that will ordinarily result in modification of the audit plan. Answer (a) is correct because results which differ from expectations may be expected to lead to modification of planned substantive procedures. Answer (b) is incorrect because the signing of the engagement letter is unlikely to result in a change in the audit plan. Answer (c) is incorrect because the communication itself of a significant deficiency is unlikely to result in a change to the audit plan. Answer (d) is incorrect because audit expected results obtained by such a procedure are unlikely to result in a change to the audit plan, since the plan is already based on expected results.

79. (d) The requirement is to determine the manner in which audit plans should be designed. Answer (d) is correct because

an audit plan should be designed so that the audit evidence gathered is sufficient to support the auditor's conclusions. Answer (a) is incorrect because, often, most audit procedures will not be performed as interim work. Answer (b) is incorrect because inherent risk need not be assessed at a low level. Answer (c) is incorrect because while providing constructive suggestions to management is desirable, the audit plan is not based on developing constructive suggestions.

80. (d) The requirement is to determine what specific audit objectives are addressed when designing an audit plan. Answer (d) is correct because in obtaining evidence in support of financial statement assertions, the auditor develops specific audit objectives in the light of those assertions. Answers (a), (b), and (c) are all incorrect because these replies do not relate specifically to the audit objectives as do the financial statement assertions.

81. (a) The requirement is to identify the statement that is always true with respect to planning an audit. Answer (a) is correct because it is acceptable for an auditor to perform a certain portion of the audit at an interim date; for example, performing a portion of planning prior to year-end is always acceptable for a continuing client. Also, when a new client has engaged an auditor prior to year-end, a portion of the audit may be conducted prior to year-end. Answer (b) is incorrect because an engagement may be accepted after the client's year-end. Answer (c) is incorrect because alternative procedures may be possible when an inventory count was not observed at year-end. Answer (d) is incorrect because final staffing decisions need not be made prior to completion of the planning stage of an audit.

82. (d) The requirement is to identify the element of the audit planning process **most** likely to be agreed upon with the client before implementation of the audit strategy. Answer (d) is correct because the auditor will ordinarily observe the counting of inventory and this will require a degree of coordination between the performance of audit procedures and client count procedures. Answer (a) is incorrect because the client will not determine the evidence to be gathered to provide a sufficient basis for the auditor's opinion. Answers (b) and (c) are incorrect because these procedures will be determined subsequent to implementation of the audit strategy.

83. (b) The requirement is to determine the manner in which an auditor plans an audit of a continuing client. Answer (b) is correct because a review of prior year working papers and the permanent file may provide useful information about the nature of the business, organizational structure, operating characteristics, and transactions that may require special attention. Answer (a) is incorrect because tests of details of transactions and balances occur subsequent to planning. Answer (c) is incorrect because while reading specialized industry journals will help the auditor to obtain a better understanding of the client's industry, it is likely to be less helpful than reviewing the working papers. Answer (d) is incorrect because a reevaluation of the client's internal control environment occurs subsequent to the ordinal planning of the audit.

84. (a) The requirement is to determine who, at a minimum, must have knowledge of the relevant professional accounting and auditing standards when an audit is being performed. Answer (a) is correct because AU-C 200 requires that, at a minimum, the auditor with final responsibility have such knowledge. Answers (b), (c), and (d) are all incorrect because they suggest a higher minimum requirement.

85. (d) The requirement is to determine why an auditor obtains knowledge about a new client's business and its industry. Answer (d) is correct because obtaining a level of knowledge of the client's business and industry enables the CPA to obtain an understanding of the events, transactions, and practices that, in the CPA's judgment, may have a significant effect on the financial statements. Answer (a) is incorrect because providing constructive suggestions is a secondary, and not the primary, reason for obtaining knowledge about a client's business and industry. Answer (b) is incorrect because while a CPA must develop an attitude of professional skepticism concerning a client, this attitude is not obtained by obtaining knowledge about the client's business and industry. Answer (c) is incorrect because information on the business and industry of a client will provide only limited information in determining whether financial statements are materially misstated, and numerous other factors are considered in evaluating audit findings.

86. (c) The requirement is to identify the **least** likely procedure to be performed in planning a financial statement audit. Answer (c) is correct because selecting a sample of vendors' invoices for comparison to receiving reports will occur normally as a part of the evidence accumulation process, not as a part of the planning of an audit. Answer (a) is incorrect because coordination of the assistance of entity personnel in data preparation occurs during planning. Answer (b) is incorrect because while planning the audit, CPAs may discuss matters that affect the audit with firm personnel responsible for providing nonaudit services to the entity. Answer (d) is incorrect because any available current year interim financial statements will be read during the planning stage.

87. (a) The requirement is to identify whether a predecessor auditor should permit a successor auditor to review working paper analyses relating to contingencies, balance sheet accounts, or both. Answer (a) is correct because AU-C 210 states that a predecessor auditor should ordinarily permit the successor to review working papers, including documentation of planning, internal control, audit results, and other matters of continuing accounting and auditing significance, such as the working paper analysis of balance sheet accounts and those relating to contingencies.

88. (d) The requirement is to determine a successor auditor's responsibility when financial statements audited by a predecessor auditor are found to require substantial revisions. Answer (d) is correct because when a successor auditor becomes aware of information that indicates that financial statements reported on by the predecessor may require revision, the successor should request that the client arrange a meeting among the three parties to discuss and attempt to resolve the matter. Answer (a) is incorrect because

the successor is not required to notify the audit committee and stockholders. Answer (b) is incorrect because the client should first communicate with the predecessor before revising the financial statements. Answer (c) is incorrect because a meeting of the three parties is arranged by the client and because the situation may or may not have anything to do with the integrity of management.

89. (c) The requirement is to determine whether a successor auditor should request a new client to authorize the predecessor auditor to allow a review of the predecessor's engagement letter, working papers, or both. Answer (c) is correct because AU-C 510 states that it is advisable that a successor auditor request to be allowed to review the predecessor's working papers.

90. (b) The requirement is to identify the audit procedure that an auditor will **most** likely perform during risk assessment for a financial statement audit. Answer (b) is correct because AU-C 315 requires that an auditor perform analytical procedures such as comparing the financial statements to anticipated results during the planning stage of an audit. Answers (a), (c), and (d) are all incorrect because these procedures will all occur subsequent to planning.

91. (b) The requirement is to identify the information that is **most** likely to be communicated by a supervisor to staff assistants. Answer (b) is correct because staff assistants must be aware of how their procedures should be evaluated in order to perform these procedures effectively. Answer (a) is incorrect because some immaterial fraud may be reported to the client's audit committee. Answer (c) is incorrect because the emphasis in an audit must be on performing the audit effectively and not merely on adhering to time budgets. Answer (d) is incorrect because decisions regarding transferring documents from the current file to the permanent file are generally of less importance than the procedure suggested by answer (b).

92. (b) The requirement is to determine why the work of each assistant should be reviewed. Answer (b) is correct because AU-C 300 suggests that the work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report. Answer (a) is incorrect because CPA firms, not individual auditors within the firms, have systems of quality control. Answer (c) is incorrect because the professional standards do not in general approve specific audit procedures. Answer (d) is incorrect because while determining that the audit has been performed by persons having adequate technical training and proficiency as auditors is important, it should be addressed prior to the commencement of fieldwork.

93. (c) The requirement is to determine the proper focus of analytical procedures used during risk assessment of an audit. Answer (c) is correct because analytical procedures used during risk assessment may enhance the auditor's understanding of the client's business and significant transactions and events that have occurred since the prior audit and also may help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications.

94. (a) The requirement is to identify a **primary** purpose of performing analytical procedures during an audit's risk assessment. Answer (a) is correct because analytical procedures used during risk assessment may enhance the auditor's understanding of the client's business and significant transactions and events that have occurred since the prior audit and also may help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications. Answers (b), (c), and (d) are all incorrect because while analytical procedures may lead to the discovery of illegal acts, related-party transactions, and unauthorized transactions, this is not the primary objective.

95. (c) The requirement is to identify the type of nonfinancial information an auditor would **most** likely consider in performing analytical procedures during the risk assessment phase of an audit. Answer (c) is correct because the square footage of selling space may be used in considering the overall reasonableness of sales. Answer (a) is incorrect because while the turnover of personnel in the accounting department may provide a measure of risk relating to the accounting function, it is not ordinarily used in performing analytical procedures. Similarly, answer (b) is incorrect because while the objectivity of audit committee members is an important consideration, it is not ordinarily used in performing analytical procedures. Answer (d) is also incorrect because management's plans to repurchase stock is not directly related to analytical procedures. See AU-C 315 and AU-C 520 for information on analytical procedures.

96. (c) The requirement is to identify the reply which is consistent with an increase in the accounts receivable turnover ratio (credit sales / accounts receivable). Answer (c) is correct because not including the sale in either the 20X2 sales or year-end accounts receivable increases the ratio. For example, assume that the actual total year sales are \$100,000 and year-end receivables are \$20,000—a turnover of 5—when the sale, assume for \$5,000, is included in 20X2. Subtracting the \$5,000 from 20X2 sales and receivables results in a turnover ratio of 6.33 ($\$95,000 / \$15,000$)—an increase. Answer (a) is incorrect because the consignment increases the numerator and denominator by an equal amount—this decreases the ratio. Answer (b) is incorrect because the denominator of the ratio is likely to increase disproportionately when 30 days rather than 20 days are allowed—this results in a decrease in the ratio. Answer (d) is incorrect because one would expect a pro-rata increase in accounts receivable, thus resulting in no change to the ratio.

97. (b) The requirement is to identify which reply is consistent with an increase in a company's gross margin percentage ($[\text{sales} - \text{cost of goods sold}] / \text{sales}$). Answer (b) is correct because fixed overhead costs will not increase with the increase in units—thus allowing costs of goods sold to increase less proportionately to the increase in units sold. Answers (a) and (c) are incorrect because income taxes and sales commissions are not included in the gross margin calculation. Answer (d) is incorrect because cost of goods sold should remain the same due to the outsourcing.

98. (c) The requirement is to identify the reply that is most consistent with a decrease in the inventory turnover (cost of goods sold / inventory). Answer (c) is correct because an increase in inventory with no change in cost of goods sold will decrease the ratio. Answer (a) is incorrect because an increase in cost of goods sold will increase the ratio. Answer (b) is incorrect because the increased sales would be expected to increase the turnover ratio in year 2 since the increased sales, with no increase in inventory levels, results in an increase in the inventory turnover (through an increase in cost of goods sold), not a decrease—more clients paying their accounts does not directly affect the ratio. Answer (d) is incorrect because this will increase the turnover ratio since cost of goods sold will be overstated and inventory will be understated.

99. (c) The requirement is to identify the next step in assessing the risks of material misstatement after auditors identify risks, relate risks to what could go wrong, and consider the magnitude of risks. Answer (c) is correct because the professional standards suggest that auditors should then consider the likelihood that risks involved could result in material misstatements. Answer (a) is incorrect because the assessment is not limited to illegal acts. Answer (b) is incorrect because the complexity of transactions is not next to be considered. Answer (d) is incorrect because determining materiality levels occurs prior to this stage of the audit.

100. (b) The requirement is to identify whether substantive tests of details and/or risk assessment procedures are considered further audit procedures that may be designed after assessing the risks of material misstatement. Further audit procedures are composed of substantive procedures (tests of details and analytical procedures) and tests of controls. Answer (b) is correct because while substantive tests of details are further audit procedures, risk assessment procedures are not. Answer (a) is incorrect because risk assessment procedures are not further audit procedures. Answer (c) is incorrect because substantive tests of details are further audit procedures and because risk assessment procedures are not. Answer (d) is incorrect because substantive tests of details are further audit procedures.

101. (b) The requirement is to identify the procedure that is **least** likely to be considered a risk assessment procedure. Answer (b) is correct because confirmation is a substantive test, rather than a risk assessment procedure. Answers (a), (b), and (c) are all risk assessment procedures, as are certain inquiries of others outside the entity.

102. (d) Answer (d) is correct because significant risks often involve accounting estimates or complex accounting that involves significant judgments. Answer (a) is incorrect because routine, high-volume transactions typically have lower risk. Answer (b) is incorrect because significant risks do require special audit attention. Answer (c) is incorrect because significant risks involve items with high levels of inherent risk.

103. (a) The requirement is to identify the focus of a final wrap-up review performed by a second partner who has not been involved in the audit. Answer (a) is correct because this second or "cold" review aims at determining whether the

financial statements result in fair presentation in conformity with GAAP and with whether sufficient appropriate evidence has been obtained. Answer (b) is incorrect because most frequently fraud involving the client's management and its employees have not been discovered and, even if they have been, the focus of the review is still on the fairness of presentation of the financial statements. Answers (c) and (d) are incorrect because decisions on materiality and communications with the audit committee are only two of the many matters the review may address in an effort to address fairness of presentation of the financial statements.

104. (a) The requirement is to identify the correct statement concerning an auditor's use of the work of a specialist. Answer (a) is correct because the work of a specialist who is related to the client may be acceptable under certain circumstances. Answer (b) is incorrect because if the auditor believes that the findings of the specialist are unreasonable, it is generally appropriate to obtain the findings of another specialist. Answer (c) is incorrect because a material difference between a specialist's findings and those included in the financial statements may result in the need for an explanatory paragraph, a qualified opinion, a disclaimer, or an adverse opinion. Answer (d) is incorrect because an auditor may use a specialist in the determination of various physical characteristics of assets.

105. (a) The requirement is to identify a circumstance in which an auditor may refer to the findings of a specialist in the auditor's report. Answer (a) is correct because the auditor may refer to the specialist when the specialist's findings result in inclusion of an explanatory paragraph to an audit report, in this case on going concern status. Answers (b), (c), and (d) are all incorrect because a specialist is only referred to in an audit report when that specialist's findings identify a circumstance requiring modification of the audit report. Auditors do not modify audit reports to simply inform the user that a specialist was involved.

106. (d) The requirement is to identify the statement that is correct about the auditor's use of the work of a specialist. Answer (d) is correct because the auditor should obtain an understanding of the nature of the work performed by the specialist. Answer (a) is incorrect because ordinarily a specialist will have a basic understanding of the auditor's corroborative use of the findings. Answer (b) is incorrect because the auditor need not perform substantive procedures to verify the specialist's assumptions and findings. Answer (c) is incorrect because the client may have an understanding of the nature of the work performed by the specialist. See AU-C 620 for information on the auditor's use of the work of a specialist.

107. (b) The requirement is to identify the circumstance in which an auditor may appropriately refer to the findings of a specialist. Answer (b) is correct because an auditor may refer to a specialist when the report is being modified due to the specialist's findings. Answers (a) and (c) are incorrect because a client's familiarity with a specialist or understanding of the auditor's use of the findings of a specialist does not result in modification of the audit report. Answer (d) is incorrect because an auditor does not divide responsibility with a specialist.

108. (c) The requirement is to identify the statement that an auditor must document when using the work of a specialist. Answer (c) is correct because the specialist's understanding of the auditor's corroborative use of his or her findings must be documented. See AU-C 620 for this and other documentation requirements. Answer (a) is incorrect because no statement concerning an update of the specialist's report is required to be documented. Answer (b) is incorrect because a division of responsibility relates to circumstances in which other auditors, not specialists, are involved. Answer (d) is incorrect because an auditor will not normally issue a disclaimer related to whether the specialist's findings corroborate the representations in the financial statements. The specialist's report is only referred to when there is a material difference between the specialist's findings and the representations in the financial statements. See AU-C 620 for information on the effect of a specialist's work on an auditor's report.

109. (c) The requirement is to determine which individual is **not** considered a specialist upon whose work an independent auditor may rely. The professional standards relating to using the work of a specialist do not apply to using the work of an internal auditor. Answers (a), (b), and (d), actuary, appraiser, and engineer, respectively, are all examples of specialists per the professional standards. Note here that the question and its reply do not imply that a CPA cannot use the work of an internal auditor. What is being suggested is that an internal auditor is not considered a specialist under the professional standards.

110. (b) The requirement is to determine the matter that an auditor would communicate to those charged with governance. Answer (b) is correct because AU-C 260 requires that when the auditor is aware of such consultation with another CPA, s/he should discuss with the audit committee his/her views about significant matters that were the subject of such consultation; accordingly, such a discussion with management is to be expected. While the information suggested in answers (a), (c), and (d) may all be communicated to the audit committee, they are not included as required disclosures under AU-C 260. See AU-C 260 for the various matters that must be communicated to those charged with governance.

111. (b) The requirement is to identify the correct statement concerning an auditor's required communication with those charged with governance. Answer (b) is correct because the communication should include such information on disagreements. See AU-C 260 for this and other required communications with those charged with governance. Answer (a) is incorrect because the communication may occur before or after issuance of the auditor's report. Answer (c) is incorrect because not all matters need be communicated to management. Answer (d) is incorrect because significant adjustments need to be communicated to those charged with governance.

112. (b) The requirement is to identify the discussion that it is **least** likely that an auditor will initiate with those charged with governance. Answer (b) is correct because auditors do not generally initiate a discussion on materiality, although they do occasionally respond to such questions. See AU-C 260 for auditor communications with those charged with governance.

113. (b) The requirement is to identify the correct statement about an auditor's required communication with those charged with governance. Answer (b) is correct because the communication must include significant misstatements discovered, even if corrected by management. Answer (a) is incorrect because while such communications may be communicated to management, there is no such requirement. Answer (c) is incorrect because disagreements with management, as well as the other required disclosures, may be communicated either orally or in writing. Answer (d) is incorrect because an auditor must recommunicate such weaknesses in internal control. Also, see AU-C 260 for the matters communicated to those charged with governance.

114. (a) The requirement is to determine whether disagreements with management and initial selection of significant accounting policies need to be communicated to those charged with corporate governance. Answer (a) is correct because disagreements should be communicated directly

to those charged with corporate governance. Answer (b) is incorrect because direct communication by the auditor is not required for selection of accounting principles. Management may engage in this communication with those charged with corporate governance. Answer (c) is incorrect because the auditor only needs to make sure that management has communicated with the committee concerning initial selection of significant accounting policies in emerging areas that lack authoritative guidance. Answer (d) is incorrect because disagreements should be communicated directly to those charged with corporate governance.

115. (a) The requirement is to determine the information that an auditor should communicate to those charged with corporate governance. Answer (a) is correct because both significant audit adjustments and management's consultation with other accountants about significant accounting matters should be communicated to an audit committee. See AU-C 260 for these and other matters that should be so communicated.

Multiple-Choice Questions (1–119)

A.1. Definition of Internal Control

- Which of the following most likely would **not** be considered an inherent limitation of the potential effectiveness of an entity's internal control?
 - Incompatible duties.
 - Management override.
 - Mistakes in judgment.
 - Collusion among employees.
 - When considering internal control, an auditor should be aware of the concept of reasonable assurance, which recognizes that
 - Internal control may be ineffective due to mistakes in judgment and personal carelessness.
 - Adequate safeguards over access to assets and records should permit an entity to maintain proper accountability.
 - Establishing and maintaining internal control is an important responsibility of management.
 - The cost of an entity's internal control should not exceed the benefits expected to be derived.
 - Proper segregation of functional responsibilities calls for separation of the functions of
 - Authorization, execution, and payment.
 - Authorization, recording, and custody.
 - Custody, execution, and reporting.
 - Authorization, payment, and recording.
- ### A.2. Major Components of Internal Control
- An entity's ongoing monitoring activities often include
 - Periodic audits by the audit committee.
 - Reviewing the purchasing function.
 - The audit of the annual financial statements.
 - Control risk assessment in conjunction with quarterly reviews.
 - The overall attitude and awareness of an entity's board of directors concerning the importance of internal control usually is reflected in its
 - Computer-based controls.
 - System of segregation of duties.
 - Control environment.
 - Safeguards over access to assets.
 - Management philosophy and operating style **most** likely would have a significant influence on an entity's control environment when
 - The internal auditor reports directly to management.
 - Management is dominated by one individual.
 - Accurate management job descriptions delineate specific duties.

- The audit committee actively oversees the financial reporting process.

- Which of the following factors are included in an entity's control environment?

	Audit committee	Integrity and ethical values	Organizational
a.	Yes	Yes	No
b.	Yes	No	Yes
c.	No	Yes	Yes
d.	Yes	Yes	Yes

- Which of the following is **not** a component of an entity's internal control?

- Control risk.
- Control activities.
- Monitoring.
- Control environment.

A.3. Related Topics

- Which of the following is a provision of the Foreign Corrupt Practices Act?
 - It is a criminal offense for an auditor to fail to detect and report a bribe paid by an American business entity to a foreign official for the purpose of obtaining business.
 - The auditor's detection of illegal acts committed by officials of the auditor's publicly held client in conjunction with foreign officials should be reported to the Enforcement Division of the Securities and Exchange Commission.
 - If the auditor of a publicly held company concludes that the effects on the financial statements of a bribe given to a foreign official are not susceptible to reasonable estimation, the auditor's report should be modified.
 - Every publicly held company must devise, document, and maintain internal control sufficient to provide reasonable assurances that internal control objectives are met.

B.1. Obtain an Understanding of Internal Control

- An auditor suspects that certain client employees are ordering merchandise for themselves over the Internet without recording the purchase or receipt of the merchandise. When vendors' invoices arrive, one of the employees approves the invoices for payment. After the invoices are paid, the employee destroys the invoices and the related vouchers. In gathering evidence regarding the fraud, the auditor **most** likely would select items for testing from the file of all
 - Cash disbursements.
 - Approved vouchers.
 - Receiving reports.
 - Vendors' invoices.

11. Which of the following procedures **most** likely would provide an auditor with evidence about whether an entity's internal control activities are suitably designed to prevent or detect material misstatements?

- a. Reperforming the activities for a sample of transactions.
- b. Performing analytical procedures using data aggregated at a high level.
- c. Vouching a sample of transactions directly related to the activities.
- d. Observing the entity's personnel applying the activities.

12. Which statement is correct concerning the relevance of various types of controls to a financial audit?

- a. An auditor may ordinarily ignore a consideration of controls when a substantive audit approach is taken.
- b. Controls over the reliability of financial reporting are ordinarily most directly relevant to an audit, but other controls may also be relevant.
- c. Controls over safeguarding of assets and liabilities are of primary importance, while controls over the reliability of financial reporting may also be relevant.
- d. All controls are ordinarily relevant to an audit.

13. In an audit of financial statements in accordance with generally accepted auditing standards, an auditor is required to

- a. Document the auditor's understanding of the entity's internal control.
- b. Search for significant deficiencies in the operation of internal control.
- c. Perform tests of controls to evaluate the effectiveness of the entity's internal control.
- d. Determine whether controls are suitably designed to prevent or detect material misstatements.

14. In obtaining an understanding of an entity's internal control relevant to audit planning, an auditor is required to obtain knowledge about the

- a. Design of the controls pertaining to internal control components.
- b. Effectiveness of controls that have been implemented.
- c. Consistency with which controls are currently being applied.
- d. Controls related to each principal transaction class and account balance.

15. An auditor should obtain sufficient knowledge of an entity's information system to understand the

- a. Safeguards used to limit access to computer facilities.
- b. Process used to prepare significant accounting estimates.
- c. Controls used to assure proper authorization of transactions.
- d. Controls used to detect the concealment of fraud.

16. When obtaining an understanding of an entity's internal control, an auditor should concentrate on the substance of controls rather than their form because

- a. The controls may be operating effectively but may **not** be documented.
- b. Management may establish appropriate controls but **not** enforce compliance with them.
- c. The controls may be so inappropriate that **no** reliance is contemplated by the auditor.
- d. Management may implement controls whose costs exceed their benefits.

17. Decision tables differ from program flowcharts in that decision tables emphasize

- a. Ease of manageability for complex programs.
- b. Logical relationships among conditions and actions.
- c. Cost benefit factors justifying the program.
- d. The sequence in which operations are performed.

18. During the consideration of internal control in a financial statement audit, an auditor is **not** obligated to

- a. Search for significant deficiencies in the operation of the internal control.
- b. Understand the internal control and the information system.
- c. Determine whether the control activities relevant to audit planning have been implemented.
- d. Perform procedures to understand the design of internal control.

19. A **primary** objective of procedures performed to obtain an understanding of internal control is to provide an auditor with

- a. Knowledge necessary to assess the risks of material misstatements.
- b. Evidence to use in assessing inherent risk.
- c. A basis for modifying tests of controls.
- d. An evaluation of the consistency of application of management's policies.

20. Which of the following statements regarding auditor documentation of the client's internal control is correct?

- a. Documentation must include flowcharts.
- b. Documentation must include procedural write-ups.
- c. No documentation is necessary although it is desirable.
- d. No one particular form of documentation is necessary, and the extent of documentation may vary.

21. In obtaining an understanding of an entity's internal control, an auditor is required to obtain knowledge about the

	Operating effectiveness of controls	Design of controls
a.	Yes	Yes
b.	No	Yes
c.	Yes	No
d.	No	No

B.2. Assess Risks of Material Misstatement and Design Further Audit Procedures

22. Which of the following may **not** be required on a particular audit of a nonissuer (nonpublic) company?

- a. Risk assessment procedures.
- b. Tests of controls.
- c. Substantive procedures.
- d. Analytical procedures.

23. Control risk should be assessed in terms of

- a. Specific controls.
- b. Types of potential fraud.
- c. Financial statement assertions.
- d. Control environment factors.

24. After assessing control risk, an auditor desires to seek a further reduction in the assessed level of control risk. At this time, the auditor would consider whether

- a. It would be efficient to obtain an understanding of the entity's information system.
- b. The entity's controls have been implemented.
- c. The entity's controls pertain to any financial statement assertions.
- d. Additional audit evidence sufficient to support a further reduction is likely to be available.

25. Assessing control risk at a low level **most** likely would involve

- a. Performing more extensive substantive tests with larger sample sizes than originally planned.
- b. Reducing inherent risk for most of the assertions relevant to significant account balances.
- c. Changing the timing of substantive tests by omitting interim-date testing and performing the tests at year-end.
- d. Identifying specific controls relevant to specific assertions.

26. An auditor assesses control risk because it

- a. Is relevant to the auditor's understanding of the control environment.
- b. Provides assurance that the auditor's materiality levels are appropriate.
- c. Indicates to the auditor where inherent risk may be the greatest.
- d. Affects the level of detection risk that the auditor may accept.

27. When an auditor increases the assessed level of control risk because certain control activities were determined to be ineffective, the auditor would **most** likely increase the

- a. Extent of tests of controls.
- b. Level of detection risk.
- c. Extent of tests of details.
- d. Level of inherent risk.

28. An auditor uses the knowledge provided by the understanding of internal control and the assessed level of the risk of material misstatement primarily to

- a. Determine whether procedures and records concerning the safeguarding of assets are reliable.
- b. Ascertain whether the opportunities to allow any person to both perpetrate and conceal fraud are minimized.
- c. Modify the initial assessments of inherent risk and preliminary judgments about materiality levels.
- d. Determine the nature, timing, and extent of substantive tests for financial statement assertions.

29. An auditor may compensate for a weakness in internal control by increasing the

- a. Level of detection risk.
- b. Extent of tests of controls.
- c. Preliminary judgment about audit risk.
- d. Extent of analytical procedures.

30. Which of the following statements is correct concerning an auditor's assessment of control risk?

- a. Assessing control risk may be performed concurrently during an audit with obtaining an understanding of the entity's internal control.
- b. Evidence about the operation of internal control in prior audits may not be considered during the current year's assessment of control risk.
- c. The basis for an auditor's conclusions about the assessed level of control risk need not be documented unless control risk is assessed at the maximum level.
- d. The lower the assessed level of control risk, the less assurance the evidence must provide that the control procedures are operating effectively.

31. Regardless of the assessed level of control risk, an auditor would perform some

- a. Tests of controls to determine the effectiveness of internal control policies.
- b. Analytical procedures to verify the design of internal control.
- c. Substantive tests to restrict detection risk for significant transaction classes.
- d. Dual-purpose tests to evaluate both the risk of monetary misstatement and preliminary control risk.

B.3. Perform Tests of Controls

32. How frequently must an auditor test operating effectiveness of controls that appear to function as they have in past years and on which the auditor wishes to rely in the current year?

- a. Monthly.
- b. Each audit.
- c. At least every second audit.
- d. At least every third audit.

33. Before assessing control risk at a level lower than the maximum, the auditor obtains reasonable assurance that controls are in use and operating effectively. This assurance is **most** likely obtained in part by

- a. Preparing flowcharts.
 - b. Performing substantive tests.
 - c. Analyzing tests of trends and ratios.
 - d. Inspection of documents.
34. An auditor generally tests the segregation of duties related to inventory by
- a. Personal inquiry and observation.
 - b. Test counts and cutoff procedures.
 - c. Analytical procedures and invoice recomputation.
 - d. Document inspection and reconciliation.
35. The objective of tests of details of transactions performed as tests of controls is to
- a. Monitor the design and use of entity documents such as prenumbered shipping forms.
 - b. Determine whether controls have been implemented.
 - c. Detect material misstatements in the account balances of the financial statements.
 - d. Evaluate whether controls operated effectively.
36. After obtaining an understanding of internal control and assessing the risk of material misstatement, an auditor decided to perform tests of controls. The auditor **most** likely decided that
- a. It would be efficient to perform tests of controls that would result in a reduction in planned substantive tests.
 - b. Additional evidence to support a further reduction in the risk of material misstatement is **not** available.
 - c. An increase in the assessed level of the risk of material misstatement is justified for certain financial statement assertions.
 - d. There were many internal control weaknesses that could allow misstatements to enter the accounting system.
37. In assessing control risk, an auditor ordinarily selects from a variety of techniques, including
- a. Inquiry and analytical procedures.
 - b. Repurchase and observation.
 - c. Comparison and confirmation.
 - d. Inspection and verification.
38. Which of the following types of evidence would an auditor **most** likely examine to determine whether controls are operating as designed?
- a. Confirmations of receivables verifying account balances.
 - b. Letters of representations corroborating inventory pricing.
 - c. Attorneys' responses to the auditor's inquiries.
 - d. Client records documenting the use of computer programs.
39. Which of the following is **not** a step in an auditor's assessment of control risk?
- a. Evaluate the effectiveness of internal control with tests of controls.
 - b. Obtain an understanding of the entity's information system and control environment.
 - c. Perform tests of details of transactions to detect material misstatements in the financial statements.
 - d. Consider whether controls can have a pervasive effect on financial statement assertions.
40. To obtain audit evidence about control risk, an auditor selects tests from a variety of techniques including
- a. Inquiry.
 - b. Analytical procedures.
 - c. Calculation.
 - d. Confirmation.
41. Which of the following is **least** likely to be evidence the auditor examines to determine whether controls are operating effectively?
- a. Records documenting usage of computer programs.
 - b. Canceled supporting documents.
 - c. Confirmations of accounts receivable.
 - d. Signatures on authorization forms.
- C.1. Sales, Receivables, and Cash Receipts**
42. Which of the following procedures concerning accounts receivable would an auditor **most** likely perform to obtain evidence in support of an assessed level of control risk below the maximum?
- a. Observing an entity's employee prepare the schedule of past due accounts receivable.
 - b. Sending confirmation requests to an entity's principal customers to verify the existence of accounts receivable.
 - c. Inspecting an entity's analysis of accounts receivable for unusual balances.
 - d. Comparing an entity's uncollectible accounts expense to actual uncollectible accounts receivable.
43. Which of the following procedures would an auditor **most** likely perform to test controls relating to management's assertion about the completeness of cash receipts for cash sales at a retail outlet?
- a. Observe the consistency of the employees' use of cash registers and tapes.
 - b. Inquire about employees' access to recorded but undeposited cash.
 - c. Trace deposits in the cash receipts journal to the cash balance in the general ledger.
 - d. Compare the cash balance in the general ledger with the bank confirmation request.
44. Sound internal control dictates that immediately upon receiving checks from customers by mail, a responsible employee should
- a. Add the checks to the daily cash summary.
 - b. Verify that each check is supported by a prenumbered sales invoice.
 - c. Prepare a duplicate listing of checks received.
 - d. Record the checks in the cash receipts journal.

45. Tracing shipping documents to prenumbered sales invoices provides evidence that

- a. No duplicate shipments or billings occurred.
- b. Shipments to customers were properly invoiced.
- c. All goods ordered by customers were shipped.
- d. All prenumbered sales invoices were accounted for.

46. Which of the following controls **most** likely would reduce the risk of diversion of customer receipts by an entity's employees?

- a. A bank lockbox system.
- b. Prenumbered remittance advices.
- c. Monthly bank reconciliations.
- d. Daily deposit of cash receipts.

47. An auditor suspects that a client's cashier is misappropriating cash receipts for personal use by lapping customer checks received in the mail. In attempting to uncover this embezzlement scheme, the auditor **most** likely would compare the

- a. Dates checks are deposited per bank statements with the dates remittance credits are recorded.
- b. Daily cash summaries with the sums of the cash receipts journal entries.
- c. Individual bank deposit slips with the details of the monthly bank statements.
- d. Dates uncollectible accounts are authorized to be written off with the dates the write-offs are actually recorded.

48. Upon receipt of customers' checks in the mailroom, a responsible employee should prepare a remittance listing that is forwarded to the cashier. A copy of the listing should be sent to the

- a. Internal auditor to investigate the listing for unusual transactions.
- b. Treasurer to compare the listing with the monthly bank statement.
- c. Accounts receivable bookkeeper to update the subsidiary accounts receivable records.
- d. Entity's bank to compare the listing with the cashier's deposit slip.

49. Which of the following procedures **most** likely would **not** be a control designed to reduce the risk of misstatements in the billing process?

- a. Comparing control totals for shipping documents with corresponding totals for sales invoices.
- b. Using computer programmed controls on the pricing and mathematical accuracy of sales invoices.
- c. Matching shipping documents with approved sales orders before invoice preparation.
- d. Reconciling the control totals for sales invoices with the accounts receivable subsidiary ledger.

50. Which of the following audit procedures would an auditor **most** likely perform to test controls relating to management's assertion concerning the completeness of sales transactions?

- a. Verify that extensions and footings on the entity's sales invoices and monthly customer statements have been recomputed.

b. Inspect the entity's reports of prenumbered shipping documents that have **not** been recorded in the sales journal.

- c. Compare the invoiced prices on prenumbered sales invoices to the entity's authorized price list.
- d. Inquire about the entity's credit granting policies and the consistent application of credit checks.

51. Which of the following controls **most** likely would assure that all billed sales are correctly posted to the accounts receivable ledger?

- a. Daily sales summaries are compared to daily postings to the accounts receivable ledger.
- b. Each sales invoice is supported by a prenumbered shipping document.
- c. The accounts receivable ledger is reconciled daily to the control account in the general ledger.
- d. Each shipment on credit is supported by a prenumbered sales invoice.

52. An auditor tests an entity's policy of obtaining credit approval before shipping goods to customers in support of management's financial statement assertion of

- a. Valuation or allocation.
- b. Completeness.
- c. Existence or occurrence.
- d. Rights and obligations.

53. Which of the following controls **most** likely would help ensure that all credit sales transactions of an entity are recorded?

- a. The billing department supervisor sends copies of approved sales orders to the credit department for comparison to authorized credit limits and current customer account balances.
- b. The accounting department supervisor independently reconciles the accounts receivable subsidiary ledger to the accounts receivable control account monthly.
- c. The accounting department supervisor controls the mailing of monthly statements to customers and investigates any differences reported by customers.
- d. The billing department supervisor matches prenumbered shipping documents with entries in the sales journal.

54. Which of the following controls **most** likely would be effective in offsetting the tendency of sales personnel to maximize sales volume at the expense of high bad debt write-offs?

- a. Employees responsible for authorizing sales and bad debt write-offs are denied access to cash.
- b. Shipping documents and sales invoices are matched by an employee who does not have authority to write off bad debts.
- c. Employees involved in the credit-granting function are separated from the sales function.
- d. Subsidiary accounts receivable records are reconciled to the control account by an employee independent of the authorization of credit.

55. Proper authorization of write-offs of uncollectible accounts should be approved in which of the following departments?

- a. Accounts receivable.
- b. Credit.
- c. Accounts payable.
- d. Treasurer.

56. Employers bond employees who handle cash receipts because fidelity bonds reduce the possibility of employing dishonest individuals and

- a. Protect employees who make unintentional misstatements from possible monetary damages resulting from their misstatements.
- b. Deter dishonesty by making employees aware that insurance companies may investigate and prosecute dishonest acts.
- c. Facilitate an independent monitoring of the receiving and depositing of cash receipts.
- d. Force employees in positions of trust to take periodic vacations and rotate their assigned duties.

57. During the consideration of a small business client's internal control, the auditor discovered that the accounts receivable clerk approves credit memos and has access to cash. Which of the following controls would be most effective in offsetting this weakness?

- a. The owner reviews errors in billings to customers and postings to the subsidiary ledger.
- b. The controller receives the monthly bank statement directly and reconciles the checking accounts.
- c. The owner reviews credit memos after they are recorded.
- d. The controller reconciles the total of the detail accounts receivable accounts to the amount shown in the ledger.

58. When a customer fails to include a remittance advice with a payment, it is common practice for the person opening the mail to prepare one. Consequently, mail should be opened by which of the following four company employees?

- a. Credit manager.
- b. Receptionist.
- c. Sales manager.
- d. Accounts receivable clerk.

C.2. Purchases, Payables, and Cash Disbursements

59. To provide assurance that each voucher is submitted and paid only once, an auditor **most** likely would examine a sample of paid vouchers and determine whether each voucher is

- a. Supported by a vendor's invoice.
- b. Stamped "paid" by the check signer.
- c. Prenumbered and accounted for.
- d. Approved for authorized purchases.

60. In testing controls over cash disbursements, an auditor **most** likely would determine that the person who signs checks also

- a. Reviews the monthly bank reconciliation.
- b. Returns the checks to accounts payable.
- c. Is denied access to the supporting documents.
- d. Is responsible for mailing the checks.

61. In assessing control risk for purchases, an auditor vouches a sample of entries in the voucher register to the supporting documents. Which assertion would this test of controls **most** likely support?

- a. Completeness.
- b. Existence or occurrence.
- c. Valuation or allocation.
- d. Rights and obligations.

62. Which of the following controls is **not** usually performed in the vouchers payable department?

- a. Matching the vendor's invoice with the related receiving report.
- b. Approving vouchers for payment by having an authorized employee sign the vouchers.
- c. Indicating the asset and expense accounts to be debited.
- d. Accounting for unused prenumbered purchase orders and receiving reports.

63. With properly designed internal control, the same employee **most** likely would match vendors' invoices with receiving reports and also

- a. Post the detailed accounts payable records.
- b. Recompute the calculations on vendors' invoices.
- c. Reconcile the accounts payable ledger.
- d. Cancel vendors' invoices after payment.

64. An entity's internal control requires for every check request that there be an approved voucher, supported by a prenumbered purchase order and a prenumbered receiving report. To determine whether checks are being issued for unauthorized expenditures, an auditor **most** likely would select items for testing from the population of all

- a. Purchase orders.
- b. Canceled checks.
- c. Receiving reports.
- d. Approved vouchers.

65. Which of the following questions would **most** likely be included in an internal control questionnaire concerning the completeness assertion for purchases?

- a. Is an authorized purchase order required before the receiving department can accept a shipment or the vouchers payable department can record a voucher?
- b. Are purchase requisitions prenumbered and independently matched with vendor invoices?
- c. Is the unpaid voucher file periodically reconciled with inventory records by an employee who does not have access to purchase requisitions?
- d. Are purchase orders, receiving reports, and vouchers prenumbered and periodically accounted for?

66. For effective internal control, the accounts payable department generally should

- a. Stamp, perforate, or otherwise cancel supporting documentation after payment is mailed.
- b. Ascertain that each requisition is approved as to price, quantity, and quality by an authorized employee.
- c. Obliterate the quantity ordered on the receiving department copy of the purchase order.
- d. Establish the agreement of the vendor's invoice with the receiving report and purchase order.

67. Internal control is strengthened when the quantity of merchandise ordered is omitted from the copy of the purchase order sent to the

- a. Department that initiated the requisition.
- b. Receiving department.
- c. Purchasing agent.
- d. Accounts payable department.

68. A client erroneously recorded a large purchase twice. Which of the following internal control measures would be **most** likely to detect this error in a timely and efficient manner?

- a. Footing the purchases journal.
- b. Reconciling vendors' monthly statements with subsidiary payable ledger accounts.
- c. Tracing totals from the purchases journal to the ledger accounts.
- d. Sending written quarterly confirmations to all vendors.

69. With well-designed internal control, employees in the same department **most** likely would approve purchase orders, and also

- a. Reconcile the open invoice file.
- b. Inspect goods upon receipt.
- c. Authorize requisitions of goods.
- d. Negotiate terms with vendors.

C.3. Inventories and Production

70. In obtaining an understanding of a manufacturing entity's internal control over inventory balances, an auditor most likely would

- a. Analyze the liquidity and turnover ratios of the inventory.
- b. Perform analytical procedures designed to identify cost variances.
- c. Review the entity's descriptions of inventory policies and procedures.
- d. Perform test counts of inventory during the entity's physical count.

71. Which of the following controls **most** likely would be used to maintain accurate inventory records?

- a. Perpetual inventory records are periodically compared with the current cost of individual inventory items.
- b. A just-in-time inventory ordering system keeps inventory levels to a desired minimum.

c. Requisitions, receiving reports, and purchase orders are independently matched before payment is approved.

- d. Periodic inventory counts are used to adjust the perpetual inventory records.

72. A client maintains perpetual inventory records in both quantities and dollars. If the assessed level of control risk is high, an auditor would probably

- a. Insist that the client perform physical counts of inventory items several times during the year.
- b. Apply gross profit tests to ascertain the reasonableness of the physical counts.
- c. Increase the extent of tests of controls of the inventory cycle.
- d. Request the client to schedule the physical inventory count at the end of the year.

73. Which of the following controls **most** likely addresses the completeness assertion for inventory?

- a. Work in process account is periodically reconciled with subsidiary records.
- b. Employees responsible for custody of finished goods do **not** perform the receiving function.
- c. Receiving reports are prenumbered and periodically reconciled.
- d. There is a separation of duties between payroll department and inventory accounting personnel.

74. Sound internal control dictates that defective merchandise returned by customers should be presented initially to the

- a. Salesclerk.
- b. Purchasing clerk.
- c. Receiving clerk.
- d. Inventory control clerk.

75. Alpha Company uses its sales invoices for posting perpetual inventory records. Inadequate controls over the invoicing function allow goods to be shipped that are not invoiced. The inadequate controls could cause an

- a. Understatement of revenues, receivables, and inventory.
- b. Overstatement of revenues and receivables, and an understatement of inventory.
- c. Understatement of revenues and receivables, and an overstatement of inventory.
- d. Overstatement of revenues, receivables, and inventory.

76. Which of the following is a question that the auditor would expect to find on the production cycle section of an internal control questionnaire?

- a. Are vendors' invoices for raw materials approved for payment by an employee who is independent of the cash disbursements function?
- b. Are signed checks for the purchase of raw materials mailed directly after signing without being returned to the person who authorized the invoice processing?

- c. Are all releases by storekeepers of raw materials from storage based on approved requisition documents?
- d. Are details of individual disbursements for raw materials balanced with the total to be posted to the appropriate general ledger account?

77. The objectives of internal control for a production cycle are to provide assurance that transactions are properly executed and recorded, and that

- a. Production orders are prenumbered and signed by a supervisor.
- b. Custody of work in process and of finished goods is properly maintained.
- c. Independent internal verification of activity reports is established.
- d. Transfers to finished goods are documented by a completed production report and a quality control report.

C.4. Personnel and Payroll

78. An auditor vouched data for a sample of employees in a payroll register to approved clock card data to provide assurance that

- a. Payments to employees are computed at authorized rates.
- b. Employees work the number of hours for which they are paid.
- c. Segregation of duties exist between the preparation and distribution of the payroll.
- d. Controls relating to unclaimed payroll checks are operating effectively.

79. Which of the following is a control that **most** likely could help prevent employee payroll fraud?

- a. The personnel department promptly sends employee termination notices to the payroll supervisor.
- b. Employees who distribute payroll checks forward unclaimed payroll checks to the absent employees' supervisors.
- c. Salary rates resulting from new hires are approved by the payroll supervisor.
- d. Total hours used for determination of gross pay are calculated by the payroll supervisor.

80. In determining the effectiveness of an entity's controls relating to the existence or occurrence assertion for payroll transactions, an auditor **most** likely would inquire about and

- a. Observe the segregation of duties concerning personnel responsibilities and payroll disbursement.
- b. Inspect evidence of accounting for prenumbered payroll checks.
- c. Recompute the payroll deductions for employee fringe benefits.
- d. Verify the preparation of the monthly payroll account bank reconciliation.

81. An auditor **most** likely would assess control risk at a high level if the payroll department supervisor is responsible for

- a. Examining authorization forms for new employees.
- b. Comparing payroll registers with original batch transmittal data.
- c. Authorizing payroll rate changes for all employees.
- d. Hiring all subordinate payroll department employees.

82. Which of the following controls **most** likely would prevent direct labor hours from being charged to manufacturing overhead?

- a. Periodic independent counts of work in process for comparison to recorded amounts.
- b. Comparison of daily journal entries with approved production orders.
- c. Use of time tickets to record actual labor worked on production orders.
- d. Reconciliation of work-in-process inventory with periodic cost budgets.

83. In meeting the control objective of safeguarding of assets, which department should be responsible for

	Distribution of paychecks	Custody of unclaimed paychecks
a.	Treasurer	Treasurer
b.	Payroll	Treasurer
c.	Treasurer	Payroll
d.	Payroll	Payroll

84. Proper internal control over the cash payroll function would mandate which of the following?

- a. The payroll clerk should fill the envelopes with cash and a computation of the net wages.
- b. Unclaimed pay envelopes should be retained by the paymaster.
- c. Each employee should be asked to sign a receipt.
- d. A separate checking account for payroll be maintained.

85. The purpose of segregating the duties of hiring personnel and distributing payroll checks is to separate the

- a. Authorization of transactions from the custody of related assets.
- b. Operational responsibility from the recordkeeping responsibility.
- c. Human resources function from the controllership function.
- d. Administrative controls from the internal accounting controls.

86. To minimize the opportunities for fraud, unclaimed cash payroll should be

- a. Deposited in a safe-deposit box.
- b. Held by the payroll custodian.
- c. Deposited in a special bank account.
- d. Held by the controller.

87. The auditor may observe the distribution of paychecks to ascertain whether

- a. Pay rate authorization is properly separated from the operating function.
- b. Deductions from gross pay are calculated correctly and are properly authorized.
- c. Employees of record actually exist and are employed by the client.
- d. Paychecks agree with the payroll register and the time cards.

88. Which of the following departments **most** likely would approve changes in pay rates and deductions from employee salaries?

- a. Personnel.
- b. Treasurer.
- c. Controller.
- d. Payroll.

C.5. Financing

89. Which of the following questions would an auditor **most** likely include on an internal control questionnaire for notes payable?

- a. Are assets that collateralize notes payable critically needed for the entity's continued existence?
- b. Are two or more authorized signatures required on checks that repay notes payable?
- c. Are the proceeds from notes payable used for the purchase of noncurrent assets?
- d. Are direct borrowings on notes payable authorized by the board of directors?

90. The **primary** responsibility of a bank acting as registrar of capital stock is to

- a. Ascertain that dividends declared do **not** exceed the statutory amount allowable in the state of incorporation.
- b. Account for stock certificates by comparing the total shares outstanding to the total in the shareholders subsidiary ledger.
- c. Act as an independent third party between the board of directors and outside investors concerning mergers, acquisitions, and the sale of treasury stock.
- d. Verify that stock is issued in accordance with the authorization of the board of directors and the articles of incorporation.

91. Where no independent stock transfer agents are employed and the corporation issues its own stocks and maintains stock records, canceled stock certificates should

- a. Be defaced to prevent reissuance and attached to their corresponding stubs.
- b. Not be defaced but segregated from other stock certificates and retained in a canceled certificates file.
- c. Be destroyed to prevent fraudulent reissuance.
- d. Be defaced and sent to the secretary of state.

C.6. Investing

92. Which of the following is **not** a control that is designed to protect investment securities?

- a. Custody over securities should be limited to individuals who have recordkeeping responsibility over the securities.
- b. Securities should be properly controlled physically in order to prevent unauthorized usage.
- c. Access to securities should be vested in more than one individual.
- d. Securities should be registered in the name of the owner.

93. Which of the following controls would a company **most** likely use to safeguard marketable securities when an independent trust agent is **not** employed?

- a. The investment committee of the board of directors periodically reviews the investment decisions delegated to the treasurer.
- b. Two company officials have joint control of marketable securities, which are kept in a bank safe-deposit box.
- c. The internal auditor and the controller independently trace all purchases and sales of marketable securities from the subsidiary ledgers to the general ledger.
- d. The chairman of the board verifies the marketable securities, which are kept in a bank safe-deposit box, each year on the balance sheet date.

94. A weakness in internal control over recording retirements of equipment may cause an auditor to

- a. Inspect certain items of equipment in the plant and trace those items to the accounting records.
- b. Review the subsidiary ledger to ascertain whether depreciation was taken on each item of equipment during the year.
- c. Trace additions to the "other assets" account to search for equipment that is still on hand but no longer being used.
- d. Select certain items of equipment from the accounting records and locate them in the plant.

95. Which of the following questions would an auditor **least** likely include on an internal control questionnaire concerning the initiation and execution of equipment transactions?

- a. Are requests for major repairs approved at a higher level than the department initiating the request?
- b. Are prenumbered purchase orders used for equipment and periodically accounted for?
- c. Are requests for purchases of equipment reviewed for consideration of soliciting competitive bids?
- d. Are procedures in place to monitor and properly restrict access to equipment?

96. Which of the following controls would be most effective in assuring that the proper custody of assets in the investing cycle is maintained?

- a. Direct access to securities in the safe-deposit box is limited to only one corporate officer.

- b. Personnel who post investment transactions to the general ledger are **not** permitted to update the investment subsidiary ledger.
- c. The purchase and sale of investments are executed on the specific authorization of the board of directors.
- d. The recorded balances in the investment subsidiary ledger are periodically compared with the contents of the safe-deposit box by independent personnel.

97. A company holds bearer bonds as a short-term investment. Responsibility for custody of these bonds and submission of coupons for periodic interest collections probably should be delegated to the

- a. Chief Accountant.
- b. Internal Auditor.
- c. Cashier.
- d. Treasurer.

98. Which of the following controls would an entity **most** likely use to assist in satisfying the completeness assertion related to long-term investments?

- a. Senior management verifies that securities in the bank safe-deposit box are registered in the entity's name.
- b. The internal auditor compares the securities in the bank safe-deposit box with recorded investments.
- c. The treasurer vouches the acquisition of securities by comparing brokers' advices with canceled checks.
- d. The controller compares the current market prices of recorded investments with the brokers' advices on file.

99. Which of the following controls would an entity **most** likely use in safeguarding against the loss of marketable securities?

- a. An independent trust company that has no direct contact with the employees who have recordkeeping responsibilities has possession of the securities.
- b. The internal auditor verifies the marketable securities in the entity's safe each year on the balance sheet date.
- c. The independent auditor traces all purchases and sales of marketable securities through the subsidiary ledgers to the general ledger.
- d. A designated member of the board of directors controls the securities in a bank safe-deposit box.

100. When there are numerous property and equipment transactions during the year, an auditor who plans to assess control risk at a low level usually performs

- a. Tests of controls and extensive tests of property and equipment balances at the end of the year.
- b. Analytical procedures for current year property and equipment transactions.
- c. Tests of controls and limited tests of current year property and equipment transactions.
- d. Analytical procedures for property and equipment balances at the end of the year.

C.7. Overall Internal Control Questionnaires (Checklists)

101. In general, material fraud perpetrated by which of the following are most difficult to detect?

- a. Cashier.
- b. Key punch operator.
- c. Internal auditor.
- d. Controller.

D.1. Communication of Internal Control-Related Matters

102. Which of the following is **not** an accurate statement about communication of internal control related matters to management on a nonissuer (nonpublic) company?

- a. The auditor must communicate both material weaknesses and significant deficiencies.
- b. The auditor must communicate in writing.
- c. Previously communicated weaknesses that have not been corrected need not be recommunicated.
- d. A communication indicating that no significant deficiencies were identified should not be issued.

103. Which of the following matters would an auditor **most** likely consider to be a material weakness to be communicated to those charged with governance of an audit client?

- a. Management's failure to renegotiate unfavorable long-term purchase commitments.
- b. Recurring operating losses that may indicate going concern problems.
- c. Ineffective oversight of financial reporting by those charged with governance.
- d. Management's current plans to reduce its ownership equity in the entity.

104. Which of the following statements is correct concerning significant deficiencies in an audit?

- a. An auditor is required to search for significant deficiencies during an audit.
- b. All significant deficiencies are also considered to be material weaknesses.
- c. An auditor may communicate significant deficiencies during an audit or after the audit's completion.
- d. An auditor may report that **no** significant deficiencies were noted during an audit.

105. An auditor's letter issued on significant deficiencies relating to an entity's internal control observed during a financial statement audit should

- a. Include a brief description of the tests of controls performed in searching for significant deficiencies and material weaknesses.
- b. Indicate that the significant deficiencies should be disclosed in the annual report to the entity's shareholders.

- c. Include a paragraph describing management's assertion concerning the effectiveness of internal control.
- d. Indicate that the audit's purpose was to report on the financial statements and **not** to express an opinion on internal control.

106. Which of the following statements is correct concerning an auditor's required communication of significant deficiencies?

- a. A significant deficiency previously communicated during the prior year's audit that remains uncorrected causes a scope limitation.
- b. An auditor should perform tests of controls on significant deficiencies before communicating them to the client.
- c. An auditor's report on significant deficiencies should include a restriction on the distribution of the report.
- d. An auditor should communicate significant deficiencies after tests of controls, but before commencing substantive tests.

107. Which of the following statements is correct concerning significant deficiencies noted in an audit?

- a. Significant deficiencies are material weaknesses in the design or operation of specific internal control components.
- b. The auditor is obligated to search for significant deficiencies that could adversely affect the entity's ability to record and report financial data.
- c. Significant deficiencies need not be recommunicated each year if management has acknowledged its understanding of such deficiencies.
- d. The auditor should separately communicate those significant deficiencies considered to be material weaknesses.

108. Which of the following representations should **not** be included in a report on internal control related matters noted in an audit?

- a. Significant deficiencies related to internal control exist.
- b. There are no significant deficiencies in the design or operation of internal control.
- c. Corrective follow-up action is recommended due to the relative significance of material weaknesses discovered during the audit.
- d. The auditor's consideration of internal control would not necessarily disclose all significant deficiencies that exist.

109. Which of the following statements concerning material weaknesses and significant deficiencies is correct?

- a. An auditor should not identify and communicate material weaknesses separately from significant deficiencies.
- b. Compensating controls may limit the severity of a material weakness or significant deficiency.
- c. Upon discovery an auditor should immediately report all material weaknesses and significant deficiencies identified during an audit.
- d. All significant deficiencies are material weaknesses.

110. During the audit the independent auditor identified the existence of a weakness in the client's internal control and communicated this finding in writing to the client's senior management and those charged with governance. The auditor should

- a. Consider the weakness a scope limitation and therefore disclaim an opinion.
- b. Consider the effects of the condition on the audit.
- c. Suspend all audit activities pending directions from the client's audit committee.
- d. Withdraw from the engagement.

D.2. Using the Work of Internal Auditors

111. In assessing the competence of an internal auditor, an independent CPA **most** likely would obtain information about the

- a. Quality of the internal auditor's working paper documentation.
- b. Organization's commitment to integrity and ethical values.
- c. Influence of management on the scope of the internal auditor's duties.
- d. Organizational level to which the internal auditor reports.

112. For which of the following judgments may an independent auditor share responsibility with an entity's internal auditor who is assessed to be both competent and objective?

	Assessment of inherent risk	Assessment of control risk
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

113. The work of internal auditors may affect the independent auditor's

- I. Procedures performed in obtaining an understanding of internal control.
 - II. Procedures performed in assessing the risk of material misstatement.
 - III. Substantive procedures performed in gathering direct evidence.
- a. I and II only.
 - b. I and III only.
 - c. II and III only.
 - d. I, II, and III.

114. An internal auditor's work would **most likely** affect the nature, timing, and extent of an independent CPA's auditing procedures when the internal auditor's work relates to assertions about the

- a. Existence of contingencies.
- b. Valuation of intangible assets.
- c. Existence of fixed asset additions.
- d. Valuation of related-party transactions.

115. During an audit an internal auditor may provide direct assistance to an independent CPA in

	Obtaining an understanding of internal control	Performing tests of controls	Performing substantive tests
a.	No	No	No
b.	Yes	No	No
c.	Yes	Yes	No
d.	Yes	Yes	Yes

116. When assessing the internal auditor's competence, the independent CPA should obtain information about the

- a. Organizational level to which the internal auditors report.
- b. Educational background and professional certification of the internal auditors.
- c. Policies prohibiting the internal auditors from auditing areas where relatives are employed.
- d. Internal auditors' access to records and information that is considered sensitive.

117. In assessing the competence and objectivity of an entity's internal auditor, an independent auditor would **least** likely consider information obtained from

- a. Discussions with management personnel.
- b. External quality reviews of the internal auditor's activities.
- c. Previous experience with the internal auditor.
- d. The results of analytical procedures.

118. If the independent auditors decide that the work performed by the internal auditor may have a bearing on their own procedures, they should consider the internal auditor's

- a. Competence and objectivity.
- b. Efficiency and experience.
- c. Independence and review skills.
- d. Training and supervisory skills.

119. In assessing the objectivity of internal auditors, an independent auditor should

- a. Evaluate the quality control program in effect for the internal auditors.
- b. Examine documentary evidence of the work performed by the internal auditors.
- c. Test a sample of the transactions and balances that the internal auditors examined.
- d. Determine the organizational level to which the internal auditors report..

Multiple-Choice Answers and Explanations

Answers

1. a	—	—	32. d	—	—	63. b	—	—	94. d	—	—
2. d	—	—	33. d	—	—	64. b	—	—	95. d	—	—
3. b	—	—	34. a	—	—	65. d	—	—	96. d	—	—
4. b	—	—	35. d	—	—	66. d	—	—	97. d	—	—
5. c	—	—	36. a	—	—	67. b	—	—	98. b	—	—
6. b	—	—	37. b	—	—	68. b	—	—	99. a	—	—
7. d	—	—	38. d	—	—	69. d	—	—	100. c	—	—
8. a	—	—	39. c	—	—	70. c	—	—	101. d	—	—
9. d	—	—	40. a	—	—	71. d	—	—	102. c	—	—
10. a	—	—	41. c	—	—	72. d	—	—	103. c	—	—
11. d	—	—	42. a	—	—	73. c	—	—	104. c	—	—
12. b	—	—	43. a	—	—	74. c	—	—	105. d	—	—
13. a	—	—	44. c	—	—	75. c	—	—	106. c	—	—
14. a	—	—	45. b	—	—	76. c	—	—	107. d	—	—
15. b	—	—	46. a	—	—	77. b	—	—	108. b	—	—
16. b	—	—	47. a	—	—	78. b	—	—	109. b	—	—
17. b	—	—	48. c	—	—	79. a	—	—	110. b	—	—
18. a	—	—	49. d	—	—	80. a	—	—	111. a	—	—
19. a	—	—	50. b	—	—	81. c	—	—	112. d	—	—
20. d	—	—	51. a	—	—	82. c	—	—	113. d	—	—
21. b	—	—	52. a	—	—	83. a	—	—	114. c	—	—
22. b	—	—	53. d	—	—	84. c	—	—	115. d	—	—
23. c	—	—	54. c	—	—	85. a	—	—	116. b	—	—
24. d	—	—	55. d	—	—	86. c	—	—	117. d	—	—
25. d	—	—	56. b	—	—	87. c	—	—	118. a	—	—
26. d	—	—	57. c	—	—	88. a	—	—	119. d	—	—
27. c	—	—	58. b	—	—	89. d	—	—			
28. d	—	—	59. b	—	—	90. d	—	—			
29. d	—	—	60. d	—	—	91. a	—	—	1st: ___/119 = ___%		
30. a	—	—	61. b	—	—	92. a	—	—	2nd: ___/119 = ___%		
31. c	—	—	62. d	—	—	93. b	—	—			

Explanations

1. (a) The requirement is to identify the reply that **most** likely would **not** be considered an inherent limitation of the potential effectiveness of an entity's internal control. Answer (a) is correct because incompatible duties may generally be divided among individuals in such a manner as to control the problem. Answers (b), (c), and (d) are all incorrect because management override, mistakes of judgment, and collusion among employees are all inherent limitations of internal control.

2. (d) The requirement is to identify the meaning of the concept of reasonable assurance. Answer (d) is correct because reasonable assurance recognizes that the cost of internal control should not exceed the benefits expected to be derived.

3. (b) The requirement is to identify the functions that should be segregated for effective internal control. Answer (b) is correct because authorizing transactions, recording transactions, and maintaining custody of assets should be segregated.

4. (b) The requirement is to identify the **most** likely type of ongoing monitoring activity. Answer (b) is correct because ongoing monitoring involves assessing the design and operation of controls on a timely basis and taking necessary

corrective actions and such an approach may be followed in reviewing the purchasing function. Answer (a) is incorrect because periodic audits are not ordinarily performed by the audit committee, a subcommittee of the Board of Directors. Answer (c) is incorrect because the audit of the annual financial statements is not ordinarily considered monitoring as presented in the professional standards. Answer (d) is incorrect because the meaning of the reply, control risk assessment in conjunction with quarterly reviews, is uncertain.

5. (c) The requirement is to identify where the overall attitude and awareness of an entity's board of directors concerning the importance of internal control is normally reflected. Answer (c) is correct because the control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity.

6. (b) The requirement is to identify the circumstance in which management philosophy and operating style would have a significant influence on an entity's control environment. Answer (b) is correct because management philosophy and operating style, while always important, is particularly so when management is dominated by one or a few individuals

because it may impact numerous other factors. Answer (a) is incorrect because the impact of the internal auditor reporting directly to management is likely to be less than that of answer (a). Answer (c) is incorrect because while accurate management job descriptions are desirable, they do not have as significant of an effect on management philosophy and operating style as does domination by an individual. Answer (d) is incorrect because an active audit committee might temper rather than lead to a more significant influence of management philosophy and operating style.

7. (d) The requirement is to determine which of the factors listed are included in an entity's control environment. Answer (d) is correct because the audit committee, integrity and ethical values, and organization structure are all included.

8. (a) The requirement is to identify the reply that is **not** a component of an entity's internal control. Answer (a) is correct because while auditors assess control risk as a part of their consideration of internal control, it is not a component of an entity's internal control. Answers (b), (c), and (d) are incorrect because the control environment, risk assessment, control activities, information and communication, and monitoring are the five components of an entity's internal control (AU-C 315).

9. (d) The Foreign Corrupt Practices Act makes payment of bribes to foreign officials illegal and requires publicly held companies to maintain systems of internal control sufficient to provide reasonable assurances that internal control objectives are met.

10. (a) The requirement is to determine the **most** likely population from which an auditor would sample when vendors' invoices and related vouchers relating to purchases made by employees have been destroyed. Answer (a) is correct because the disbursement will be recorded and the auditor may thus sample from that population. Answers (b) and (d) are incorrect because the related vouchers and vendors' invoices are destroyed. Answer (c) is incorrect because there is no recording of the receipt of the merchandise.

11. (d) The requirement is to identify the procedure an auditor would perform to provide evidence about whether an entity's internal control activities are suitably designed to prevent or detect material misstatements. Answer (d) is correct because AU-C 315 indicates an auditor will observe the entity's personnel applying the procedures to determine whether controls have been implemented. Answer (a) is incorrect because reperforming the activities is a test of control to help assess the operating effectiveness of a control. Answer (b) is incorrect because analytical procedures are not performed to determine whether controls are suitably designed. Answer (c) is incorrect because vouching a sample of transactions is a substantive test not directly aimed at determining whether controls are suitably designed. See AU-C 315 for a discussion of an auditor's responsibility for determining whether controls have been implemented vs. their operating effectiveness.

12. (b) The requirement is to identify the correct statement relating to the relevance of various types of controls to a financial statement audit. Answer (b) is correct because, generally, controls that are relevant to an audit pertain to the

entity's objective of preparing financial statements for external purposes. Answer (a) is incorrect because AU-C 315 makes clear that an auditor may not ignore consideration of controls under any audit approach. Answer (c) is incorrect because control over financial reporting are of primary importance. Answer (d) is incorrect because many operational and compliance related controls are not ordinarily relevant to an audit.

13. (a) The requirement is to identify the statement that represents a requirement when an audit of financial statements in accordance with generally accepted accounting principles is performed. Answer (a) is correct because AU-C 315 requires that the auditor document the understanding of the entity's internal control. Answer (b) is incorrect because while an auditor might find significant deficiencies in the operation of internal control, no such search is required. Answer (c) is incorrect because an auditor might use a substantive approach in performing an audit and thereby perform few (if any) tests of controls. Answer (d) is incorrect because while auditors must obtain knowledge of internal control sufficiently to identify types of potential misstatements, they are not required to obtain the detailed knowledge of internal control suggested by this reply.

14. (a) The requirement is to identify the knowledge that an auditor must obtain when obtaining an understanding of an entity's internal control sufficient for audit planning. Answer (a) is correct because an auditor must obtain an understanding that includes knowledge about the design of relevant controls and records and whether the client has placed those controls in operation. Answers (b) and (c) are incorrect because auditors may choose not to obtain information on operating effectiveness of controls and their consistency of application. Answer (d) is incorrect because there is no such explicit requirement relating to controls; see AU-C 315 for the necessary understanding of internal control.

15. (b) AU-C 315 states that the auditor should obtain sufficient knowledge of the information (including accounting) system to understand the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures. It also states that this knowledge is obtained to help the auditor to understand (1) the entity's classes of transactions, (2) how transactions are initiated, (3) the accounting records and support, and (4) the accounting processing involved from initiation of a transaction to its inclusion in the financial statements.

16. (b) The requirement is to determine why an auditor should concentrate on the substance of procedures rather than their form when obtaining an understanding of an entity's controls. Answer (b) is correct because management may establish appropriate controls but not act on them, thus creating a situation in which the form differs from the substance. Answer (a) is incorrect because documentation is not directly related to the issue of substance over form. Answer (c) is incorrect because inappropriate controls is only a part of an auditor concern; for example, a control may be appropriate, but it may not be operating effectively. Answer (d) is incorrect because while an auditor might suggest to management that the cost of certain controls seems to exceed their likely benefit, this is not the primary reason auditors are concerned with the substance of controls.

17. (b) Decision tables include various combinations of conditions that are matched to one of several actions. In an internal control setting, the various important controls are reviewed and, based on the combination of answers received, an action such as a decision on whether to perform tests of controls is determined. Program flowcharts simply summarize the steps involved in a program. Answer (a) is incorrect because decision tables do not emphasize the ease of manageability for complex programs. Answer (c) is incorrect because while decision tables may be designed using various cost benefit factors relating to the various conditions and actions, they do not justify the program. Answer (d) is incorrect because program flowcharts, not decision tables, emphasize the sequence in which operations are performed.
18. (a) The requirement is to identify the procedure that is **not** required to be included in an auditor's consideration of internal control. Answer (a) is correct because the auditor need not obtain evidence relating to operating effectiveness when control risk is to be assessed at the maximum level. Answer (b) is incorrect because an auditor must obtain an understanding of the internal control environment and the information system. Answers (c) and (d) are incorrect because an auditor is obligated to obtain information on the design of internal control and on whether control activities have been implemented.
19. (a) The requirement is to identify the **primary** objective of procedures performed to obtain an understanding of internal control. Answer (a) is correct because the auditor obtains a sufficient understanding of internal control to assess the risks of material misstatement and to design the nature, timing, and extent of further audit procedures. Answer (b) addresses inherent risk, the susceptibility of an assertion to material misstatement, assuming that there are no related controls. Answer (b) is incorrect since the concept of inherent risk assumes no internal control and is therefore not the primary objective. Answer (c) is incorrect because answer (a) is more complete and because decisions on modifying tests of controls are often made at a later point in the audit. Answer (d) is incorrect because the consistency of application of management's policies relates more directly to tests of controls than to obtaining an understanding of internal control.
20. (d) The requirement is to determine the correct statement with respect to the auditor's required documentation of the client's internal control. An auditor may document his/her understanding of the structure and his/her conclusions about the design of that structure in the form of answers to a questionnaire, narrative memorandums, flowcharts, decision tables, or any other form that the auditor considers appropriate in the circumstances. Answers (a) and (b) are, thus, incorrect because they suggest restrictions which do not exist in practice. Answer (c) is incorrect since at a minimum a list of reasons for nonreliance must be provided.
21. (b) In obtaining an understanding of internal control, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant controls and whether they have been implemented. Information on operating effectiveness need not be obtained unless control risk is to be assessed at a level below the maximum.
22. (b) Answer (b) is correct because tests of controls are only required when the auditor relies on the controls or substantive tests alone are not sufficient to audit particular assertions. Answers (a), (c), and (d) are incorrect because these procedures are required on every audit.
23. (c) The requirement is to identify the terms in which control risk should be assessed. Answer (c) is correct because AU-C 315 requires that control risk be assessed in terms of financial statement assertions.
24. (d) The requirement is to identify a situation in which an auditor may desire to seek a further reduction in the assessed level of control risk. Answer (d) is correct because such a reduction is only possible when additional evidence, evaluated by performing additional tests of controls, is available. Answer (a) is incorrect because auditors at this point will ordinarily already have obtained the understanding of the information system to plan the audit. Furthermore, an understanding of internal control is needed on all audits. Answer (b) is incorrect because auditors must determine that controls have been implemented in all audits. Answer (c) is incorrect because a significant number of controls always pertain to financial statement assertions.
25. (d) Assessing control risk at a low level involves (1) identifying specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions, and (2) performing tests of controls to evaluate the effectiveness of such controls. Answer (a) is incorrect because assessing control risk at a low level may lead to less extensive, not more extensive substantive tests. Answer (b) is incorrect because the actual level of inherent risk is not affected by the level of control risk. Also, one would not expect a change in the assessed level of control risk to result in a change in the assessed level of inherent risk. Answer (c) is incorrect because assessing control risk at a low level may lead to interim-date substantive testing rather than year-end testing.
26. (d) The requirement is to determine why an auditor assesses control risk. Answer (d) is correct because the assessed levels of control risk and inherent risk are used to determine the acceptable level of detection risk for financial statement assertions.
27. (c) Increases in the assessed level of the risk of material misstatement lead to decreases in the acceptable level of detection risk. Accordingly, the auditor will need to increase the extent of substantive tests such as tests of details. Answer (a) is incorrect because tests of controls are performed to reduce the assessed level of control risk only when controls are believed to be effective. Answer (b) is incorrect because the level of detection risk must be decreased, not increased. Answer (d) is incorrect because the level of inherent risk pertains to the susceptibility of an account to material misstatement independent of related controls.
28. (d) The requirement is to determine the **primary** purpose for which an auditor uses the knowledge provided by the understanding of internal control and the assessed level of the risk of material misstatement. Answer (d) is correct because the auditor uses such knowledge in determining the nature, timing, and extent of substantive tests for financial

statement assertions. Answer (a) is incorrect because it is incomplete. For example, while auditors are concerned with the safeguarding of assets, they also need to determine whether the financial statement information is accurate. Answer (b) is incorrect for reasons similar to (a) in that determining whether opportunities are available for committing and concealing fraud is incomplete since this knowledge is also used to ascertain whether the chance of errors is minimized. Answer (c) is incorrect because knowledge provided by the understanding of internal control and the assessed level of control risk is not used to modify initial assessments of inherent risk and preliminary judgments about materiality levels. This knowledge is unrelated to those processes.

29. (d) The requirement is to identify a way that an auditor may compensate for a weakness in internal control. Answer (d) is correct because increasing analytical procedures decreases detection risk in a manner which may counterbalance the condition in internal control. In effect, the weakness in internal control is compensated for by increased substantive testing. See the outline of AU-C 200 in Appendix A for the relationships among audit risk and its component risks— inherent risk, control risk, and detection risk. Answer (a) is incorrect because increasing both control risk (through a weakness in internal control) and detection risk increases audit risks. In addition, control risk and detection risk do not compensate for one another. Answer (b) is incorrect because increasing the extent of tests of controls is unlikely to be effective since the condition is known to exist. Answer (c) is incorrect because it is not generally appropriate to increase the judgment as to audit risk based on the results obtained.

30. (a) The requirement is to identify the correct statement concerning an auditor's assessment of control risk. Answer (a) is correct because AU-C 315 indicates that assessing control risk may be performed concurrently during an audit with obtaining an understanding of internal control. Answer (b) is incorrect because evidence about the operation of internal control obtained in prior audits may be considered during the current year's assessment of control risk. Answer (c) is incorrect because the basis for an auditor's conclusions about the assessed level of control risk needs to be documented when control risk is assessed at levels other than the maximum level. Answer (d) is incorrect because a lower level of control risk requires more assurance that the control procedures are operating effectively.

31. (c) The requirement is to determine the correct statement concerning the assessed level of control risk. Answer (c) is correct because ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for significant transaction classes. Answer (a) is incorrect because tests of controls are unnecessary when control risk is assessed at the maximum level. Answer (b) is incorrect because analytical procedures are not designed to verify the design of internal control. Answer (d) is incorrect because dual-purpose tests (i.e., those that serve as both substantive tests and tests of controls) are not required to be performed, and because the term "preliminary control risk" is unclear.

32. (d) The requirement is to identify how frequently controls that the auditor wishes to rely upon must be tested.

Answer (d) is correct because the professional standards require auditors to test controls at least every third year. Answer (a) is incorrect because controls need not be tested monthly. Answer (b) is incorrect because ordinarily controls need not be tested with each audit. Answer (c) is incorrect because auditors may test such controls every third year, not every second year.

33. (d) The requirement is to identify the type of audit test **most** likely to provide assurance that controls are in use and operating effectively. Answer (d) is correct because inspection of documents is a form of a test of controls, and such tests are used to obtain reasonable assurance that controls are in use and operating effectively. Answer (a) is incorrect because auditors prepare flowcharts to document a company's internal control, not to obtain assurance that controls are in use and operating effectively. Answer (b) is incorrect because substantive tests relate to the accuracy of accounts and assertions rather than testing controls directly. Answer (c) is incorrect because analyzing tests of trends and ratios is an analytical procedure that does not directly test controls.

34. (a) The requirement is to identify the appropriate procedures for testing the segregation of duties related to inventory. Answer (a) is correct because AU-C 315 suggests that when no audit trail exists (as is often the case for the segregation of duties) an auditor should use the observation and inquiry techniques.

35. (d) The requirement is to identify the objective of tests of details of transactions performed as tests of controls. Answer (d) is correct because the purpose of tests of controls is to evaluate whether internal control operates effectively. Answer (a) is incorrect because while monitoring the design and use of entity documents may be viewed as a test of controls, it is not the objective. Answer (b) is incorrect because determining whether internal control is implemented is not directly related to tests of controls; see AU-C 315 for the distinction between "implemented" and "operating effectiveness." Answer (c) is incorrect because substantive tests, not tests of controls, are focused on detection of material misstatements in the account balances of the financial statements.

36. (a) The requirement is to identify a circumstance in which an auditor may decide to perform tests of controls. Answer (a) is correct because tests of controls will be performed when they are expected to result in a cost effective reduction in planned substantive tests. Answer (b) is incorrect because tests of controls are only performed when they are likely to support a further reduction in the assessed level of the risk of material misstatement. Answer (c) is incorrect because tests of controls are designed to decrease the assessed level of the risk of material misstatement, not increase it. Answer (d) is incorrect because internal control weaknesses normally result in more substantive testing and less tests of controls.

37. (b) The requirement is to identify the most appropriate procedures for assessing control risk. Auditors perform tests of controls to obtain evidence on the operating effectiveness of controls to assess control risk. Answer (b) is correct because tests of controls include inquiries of appropriate entity personnel, inspection of documents and reports, observation of

the application of the policy or procedure, and reperformance of the application of the policy or procedure.

38. (d) The requirement is to identify the type of evidence an auditor **most** likely would examine to determine whether controls are operating as designed. Answer (d) is correct because inspection of client records documenting the use of computer programs will provide evidence to help the auditor evaluate the effectiveness of the design and operation of internal control; the client's control over use of its computer programs in this case is documentation of the use of the programs. In order to test this control, the auditor will inspect the documentation records. See AU-C 330 for information on the nature of tests of controls.

Answer (a) is incorrect because the confirmation process is most frequently considered a substantive test, not a test of a control. Answer (b) is incorrect because letters of representations provide corroborating information on various management representations obtained throughout the audit and therefore only provides limited evidence on internal control. Answer (c) is incorrect because attorneys' responses to auditor inquiries most frequently pertain to litigation, claims, and assessments.

39. (c) The requirement is to identify the procedure that is **not** a step in an auditor's assessment of control risk. Answer (c) is correct because performing tests of details of transactions to detect material misstatements pertains more directly to detection risk rather than inherent or control risk. Answer (a) is incorrect because auditors evaluate the effectiveness of internal control with tests of controls. Answer (b) is incorrect because obtaining an understanding of the entity's information system and control environment is a preliminary step for considering control risk. Answer (d) is incorrect because auditors will consider the effect of internal control on the various financial statement assertions.

40. (a) The requirement is to identify an approach that auditors use to obtain audit evidence about control risk. Answer (a) is correct because auditors test controls to provide evidence for their assessment of control risk through inquiries of appropriate personnel, inspection of documents and records, observation of the application of controls, and reperformance of the application of the policy or procedure. Answers (b), (c), and (d) are incorrect because analytical procedures, calculation, and confirmation relate more directly to substantive testing and are not primary methods to test controls for purposes of assessing control risk.

41. (c) The requirement is to identify the **least** likely type of evidence the auditor will examine to determine whether controls are operating effectively. Answer (c) is correct because confirmation of accounts receivable is a substantive test, not a test of a control. Answer (a) is incorrect because records documenting the usage of computer programs may be tested to determine whether access is appropriately controlled. Answer (b) is incorrect because examining canceled supporting documents may help the auditor to determine that the structure will not allow duplicate billing to result in multiple payments. Answer (d) is incorrect because proper signatures will help the auditor to determine whether the authorization controls are functioning adequately.

42. (a) The requirement is to identify the accounts receivable auditing procedure that an auditor would **most** likely perform to obtain support for an assessed level of control risk below the maximum. Since an auditor uses the results of tests of controls to support an assessed level of control risk below the maximum, we are attempting to identify a test of a control. Answer (a) is correct because observing an entity's employee prepare the schedule of past due accounts receivable is a test of a control to evaluate the effectiveness the process of preparing an accurate schedule of past due accounts; if the process is found to be effective it may lead to a reduction in the assessed level of control risk. Answer (b) is incorrect because the confirmation of accounts receivable is a substantive test, not a test of a control. Answer (c) is incorrect because the inspection of accounts receivable for unusual balances and comparing uncollectible accounts expense to actual accounts expense is ordinarily an analytical procedure performed as a substantive test. Answer (d) is incorrect because comparing uncollectible accounts expense to actual uncollectible accounts is ordinarily a substantive test.

43. (a) The requirement is to identify the procedure an auditor **most** likely would perform to test controls relating to management's assertion about the completeness of cash receipts for cash sales at a retail outlet. Answer (a) is correct because the use of cash registers and tapes helps assure that all such sales are recorded. Answer (b) is incorrect because the cash has already been recorded. Answer (c) is incorrect because the procedure only deals with recorded deposits, and therefore the completeness assertion is not addressed as directly as in answer (a). Answer (d) is incorrect because one would not expect the cash balance in the general ledger to agree with the bank confirmation request amount due to items in transit and outstanding at the point of reconciliation.

44. (c) The requirement is to identify the proper procedure to be performed immediately upon receipt of checks by mail. Sound internal control requires the use of adequate documentation to ensure that all transactions are properly recorded. This helps the company attain the financial statement assertion of completeness. Answer (c) is correct because the preparation of a duplicate listing of checks received provides the company with a source document of all the checks received that day. One list is then forwarded to the employee responsible for depositing the checks at the end of the day and the other list is sent to the accounting department so that they can post the amount to the cash receipts journal. Answer (a) is incorrect because the daily cash summary will ordinarily be prepared at the end of the day when all checks have been received. Answer (b) is incorrect because checks need not be compared to a sales invoice. Answer (d) is incorrect because the employee opening the mail should not also perform the recordkeeping function of recording the checks in the cash receipts journal.

45. (b) The requirement is to determine the type of evidence obtained when tracing shipping documents to prenumbered sales invoices. Answer (b) is correct because the shipping documents relate to shipments to customers, and tracing them to sales invoices will provide evidence on whether sales invoices were prepared. Answer (a) is incorrect

because duplicate shipments or billings will not in general be detected by tracing individual shipping documents to prenumbered sales invoices. Answer (c) is incorrect because an auditor will trace from customer orders to shipping documents to determine whether all goods ordered were shipped. Answer (d) is incorrect because an auditor will account for the sequence of sales invoices to determine whether all sale invoices were accounted for.

46. (a) The requirement is to identify the control **most** likely to reduce the risk of diversion of customer receipts by an entity's employees. Answer (a) is correct because a bank lockbox system eliminates employee contact with cash receipts, and thereby greatly reduces the risk of diversion by employees. Answer (b) is incorrect because remittance advices are ordinarily prenumbered using the numbering schemes of the various customers and not of the client; also, even if a prenumbering system is instituted, difficulties remain in assuring that all receipts are recorded. Answer (c) is incorrect because a monthly bank reconciliation is only likely to be effective when receipts are deposited and then abstracted. Answer (d) is incorrect because while the daily deposit of cash receipts may reduce the risk of employee diversion of receipts, the procedure is not as effective as the bank lockbox system, which eliminates employee contact with the receipts.

47. (a) The requirement is to identify the **best** listed procedure for detecting the lapping of cash receipts by the client's cashier through use of customer checks received in the mail. Answer (a) is correct because lapping will result in a delay in the recording of specific remittance credits on the financial records, but the checks will be deposited in the bank as they are received. Answer (b) is incorrect because the daily cash summaries will include the same sums as the cash receipts journal entries. Answer (c) is incorrect because the bank deposit slips will be identical to any details included in the monthly bank statements. Answer (d) is incorrect because while the write-off of a receivable may help the individual involved in the lapping to avoid repayment, no lag is to be expected between authorization of the write-off and the date it is actually recorded.

48. (c) The requirement is to determine the individual or organization to which a list of remittances should be forwarded to in addition to the cashier. Answer (c) is correct because the accounts receivable bookkeeper will use the listing to update the subsidiary accounts receivable records. Answer (a) is incorrect because internal auditors will not normally investigate each day's listing of remittances for unusual transactions. Answer (b) is incorrect because the treasurer will not in general compare daily listings to the monthly bank statement. Answer (d) is incorrect because the list will not be sent to the bank.

49. (d) The requirement is to identify the procedure that **most** likely would **not** be a control designed to reduce the risk of errors in the billing process. Answer (d) is correct because the reconciliation of the control totals for sales invoices with the accounts receivable subsidiary ledger will follow billing; thus billing errors will have already occurred. Answer (a) is incorrect because identification of differences in shipping documents and sales invoices will allow for a correction of any errors and proper billing. Answer (b) is incorrect because

computer programmed controls will assure the accuracy of the sales invoice. Answer (c) is incorrect because the matching of shipping documents with the approved sales orders will allow the preparation of a correct invoice.

50. (b) The requirement is to identify the audit procedure an auditor **most** likely would perform to test controls relating to management's assertion concerning the completeness of sales transactions. Answer (b) is correct because inspection of shipping documents that have **not** been recorded in the sales journal will possibly reveal items that have been sold (as evidenced by a shipping document) but for some reason have not been recorded as sales. Answers (a), (c), and (d) are all incorrect because verification of extension and footings, comparing invoiced prices, and inquiring about credit granting policies all relate more directly to the valuation assertion than to the completeness assertion.

51. (a) The requirement is to identify the control that **most** likely would assure that all billed sales are correctly posted to the accounts receivable ledger. Answer (a) is correct because the daily sales summary will include all "billed" sales for a particular day. Comparing this summary to the postings to the accounts receivable ledger will provide evidence on whether billed sales are correctly posted. Answer (b) is incorrect because comparing sales invoices to shipping documents provides evidence on whether invoiced sales have been shipped. Answer (c) is incorrect because reconciling the accounts receivable ledger to the control account will not provide assurance that all billed sales were posted in that both the receivable ledger and the control account may have omitted the sales. Answer (d) is incorrect because comparing shipments with sales invoices provides evidence on whether all shipments have been invoiced, not on whether all billed sales are correctly posted.

52. (a) The requirement is to determine the financial statement assertion being most directly tested when an auditor tests an entity's policy of obtaining credit approval before shipping goods to customers. Answer (a) is correct because testing credit approval helps assure that goods are shipped to customers who are likely to be able to pay; accordingly the valuation assertion for receivables is being directly tested. Answer (b) is incorrect because completeness deals with whether all transactions and accounts are recorded. Answer (c) is incorrect because existence deals with whether assets exist at a given date and whether recorded transactions have occurred during a given period. Answer (d) is incorrect because rights and obligations deal with whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date.

53. (d) The requirement is to identify the control that **most** likely would help ensure that **all** credit sales transactions are recorded. Answer (d) is correct because the matching of shipping documents with entries in the sales journal will provide assurance that all shipped items (sales) have been completely recorded. Answer (a) is incorrect because comparison of approved sales orders to authorized credit limits and balances will help ensure that customer credit limits are not exceeded, rather than the complete recording of credit sales. Answer (b) is incorrect because reconciliation

of the accounts receivable subsidiary ledger to the accounts receivable control account will provide only a limited amount of control over the complete recording of sales. The control is incomplete since, for example, a sale that has not been recorded in either the subsidiary or control accounts will not be detected. Answer (c) is incorrect because monthly statements generally will not be sent to customers to whom no sales have been recorded.

54. (c) The requirement is to identify the control that will be most effective in offsetting the tendency of sales personnel to maximize sales volume at the expense of high bad debt write-offs. Answer (c) is correct because segregation of the authorization of credit from the sales function will allow an independent review of the creditworthiness of customers. Answer (a) is incorrect because while denying access to cash by employees responsible for sales and bad debt write-offs may deter embezzlements, the problem of high bad debt write-offs is likely to remain. Answer (b) is incorrect because while so segregating the matching of shipping documents and sales invoices may help assure that items are shipped properly and subsequently recorded, it will not significantly affect bad debts. Answer (d) is incorrect because while independent reconciliation of control and subsidiary accounts receivable records may defer embezzlements, bad debt write-offs will not be affected.

55. (d) The requirement is to determine the department that should approve bad debt write-offs. The department responsible for bad debt write-offs should be independent of the sales, credit, and the recordkeeping for that function, and should have knowledge relating to the accounts. Answer (d) is correct because, in addition to being independent of the various functions, the treasurer's department is likely to have knowledge to help make proper decisions of this nature. Answers (a) and (b), accounts receivable and the credit department, are incorrect because neither department is independent of this function. Answer (c) is incorrect because while accounts payable is independent of the function, its personnel are less likely than those of the treasurer's department to have the necessary information relating to the accounts that should be written off.

56. (b) The requirement is to identify a reason that employers bond employees who handle cash receipts. Answer (b) is correct because employee knowledge that bonding companies often prosecute those accused of dishonest acts may deter employees' dishonest acts. Answer (a) is incorrect because bonding protects the employer from dishonest acts, not the employee from unintentional errors. Answer (c) is incorrect because the bonding company does not serve the role of independent monitoring of cash. Answer (d) is incorrect because while rotation of positions and forcing employees to take periodic vacations are effective controls for preventing fraud, they are not accomplished through bonding.

57. (c) The requirement is to identify the control which would offset a weakness that allowed the accounts receivable clerk to approve credit memos and to have access to cash. Note that such a weakness may lead to a fraud in which the accounts receivable clerk receives and keeps cash payments while issuing a fraudulent credit memo as the basis for a credit

to the customer's account. Answer (c) is correct because the owner's review of credit memos could help establish that fraudulent memos had not been issued for receivables which had in actuality been collected by the clerk; for example, when reviewing credit memos the owner would expect to see a receiving report for sales returns for which credit memos have been generated. Answer (a) is incorrect because the bookkeeper may be able to maintain the records in such a manner as to avoid billing errors related to the fraud, and therefore a review of billings and postings may not reveal such fraud. Answer (b) is incorrect because month-end reconciliation of checking accounts with the monthly bank statement will not reflect cash that has been improperly diverted by the accounts receivable clerk. Answer (d) is incorrect because the accounts receivable clerk should be able to maintain the detail and ledger amount in balance and thereby avoid detection.

58. (b) The requirement is to determine who should prepare a remittance advice when the customer fails to include one with a remittance. Remittances should be opened by an individual such as a receptionist who is independent of the sales function. That individual will prepare any needed remittance advices. The credit manager [answer (a)], and the sales manager [answer (c)], are incorrect because they perform an authorization function related to sales. Answer (d) is incorrect because the accounts receivable clerk performs a recordkeeping function for sales.

59. (b) The requirement is to identify the audit procedure relating to paid vouchers that will provide assurance that each voucher is submitted and paid only once. Answer (b) is correct because when the check signer stamps vouchers "paid" it is unlikely to be paid a second time since that individual will notice the stamp on the voucher the second time it is submitted for payment.

60. (d) The requirement is to determine the appropriate responsibility for the person who signs checks. Answer (d) is correct because the individual who signs checks should be responsible for mailing them so as to avoid a variety of fraud in which the checks are improperly converted into cash by company employees. Answer (a) is incorrect because the individual who reconciles the bank accounts should have no other responsibilities with respect to cash. Answer (b) is incorrect because accounts payable does not need the checks and, if they receive them, those checks may be converted into cash which is then stolen. Answer (c) is incorrect because the person who signs the checks should determine that proper supporting documents exist and should cancel that documentation after the payment is made.

61. (b) The requirement is to determine the financial statement assertion that a test of controls of vouching a sample of entries in the voucher register to the supporting documents most directly addresses. Answer (b) is correct because the existence or occurrence assertion addresses whether recorded entries are valid and the direction of this test is from the recorded entry in the voucher register to the supporting documents. Answer (a) is incorrect because completeness addresses whether all transactions and accounts are included and would involve tests tracing from support for purchases to

the recorded entry. Answers (c) and (d) are incorrect because vouching the entries provides only limited evidence on valuation and rights.

62. (d) The requirement is to determine the control that is **not** usually performed in the vouchers payable department. Answer (d) is correct because the vouchers payable department will not in general have access to unused prenumbered purchase orders and receiving reports. Answer (a) is incorrect because the vouchers payable department will match the vendor's invoice with the related receiving report to determine that the item for which the company has been billed has been received. Answer (b) is incorrect because the vouchers payable department will approve vouchers for payment when all documentation is proper and present. Answer (c) is incorrect because the vouchers payable department will code the voucher with accounts to be debited.

63. (b) The requirement is to identify the function that is consistent with matching vendors' invoices with receiving reports. Answer (b) is correct because while matching invoices and receiving reports, the employee might effectively recompute the calculations on the vendors' invoices to determine that the amounts are proper. Answers (a) and (c) are incorrect. The individual who matches the invoices and receiving reports will often also approve them for payment. Therefore, this individual should not also post accounts payable records or reconcile the accounts payable ledger. Answer (d) is incorrect because the individual who controls the signing of the checks should cancel the invoices after payment.

64. (b) The requirement is to identify the population from which items should be selected to determine whether checks are being issued for unauthorized expenditures. Answer (b) is correct because a sample of canceled checks should be selected and compared with the approved vouchers, a prenumbered purchase order and prenumbered receiving reports. A canceled check that does not have such support may have been unauthorized. Answers (a), (c), and (d) are all incorrect because selecting items from purchase orders, receiving reports, or approved vouchers will not reveal circumstances in which a check was issued without that supporting document. For example, when selecting a sample from purchase orders, one would not discover a situation in which a check had been issued without a purchase order.

65. (d) The requirement is to determine which question would **most** likely be included in an internal control questionnaire concerning the completeness assertion for purchases. Answer (d) is correct because prenumbering and accounting for purchase orders, receiving reports, and vouchers will allow a company to determine that purchases are completely recorded. For example, in examining a receiving report the client might discover that the purchase was not recorded. Answer (a) is incorrect because requiring a purchase order before a shipment is accepted will address whether or not the shipment has been ordered. Answer (b) is incorrect because matching purchase requisitions with vendor invoices does not directly address whether the purchase is recorded. Answer (c) is incorrect because the unpaid voucher file represents items

that have already been recorded, and thus will not directly address the completeness of the recording of purchases.

66. (d) The requirement is to identify the proper control pertaining to the accounts payable department. Answer (d) is correct because the accounts payable department should establish the agreement of the vendor's invoice with the purchase order and receiving report to provide assurance that the item was both ordered and received. Answer (a) is incorrect because the individual signing the check (e.g., the treasurer), not the accounts payable department, should stamp, perforate, or otherwise cancel supporting documentation after a check is signed. Answer (b) is incorrect because purchase requisitions will not normally include detailed price information.

Answer (c) is incorrect because the quantity ordered on the receiving department copy of the purchase order will already be obliterated when the purchase order is completed by the purchasing department.

67. (b) The requirement is to determine which copy of the purchase order should omit indication of the quantity of merchandise ordered. Answer (b) is correct because if the receiving department personnel are unaware of the quantities ordered, they will provide an independent count of quantities received. Answer (a) is incorrect because the department that initiated the requisition needs the merchandise, and therefore, should know what has been ordered. Answer (c) is incorrect because the purchasing agent is involved with purchasing the items and therefore must be aware of the quantity involved. Answer (d) is incorrect because the accounts payable department must reconcile the quantity received and the quantity billed to the quantity that was authorized to be purchased per the purchase order.

68. (b) The requirement is to identify the audit procedure which would **most** likely detect a client error in recording a large purchase. Answer (b) is correct because reconciling the vendors' monthly statements with the subsidiary ledger for payables should disclose a difference in the month following the error. Answer (a), footing the purchases journal, is unlikely to detect the error since the journal's totals will have been mathematically accumulated properly. Answer (c) is incorrect because the incorrect total will be reflected in both the purchases journal and in the ledger accounts. Answer (d) is incorrect because such confirmations will only detect the error quarterly which is neither timely nor efficient.

69. (d) The requirement is to identify a function that is compatible with the approval of purchase orders. Answer (d) is correct because the purchases department will normally approve purchase orders (generated from user departments or stores) and negotiate terms of purchase with vendors. Answer (a) is incorrect because while the purchases department may reconcile the open invoice file, this is primarily a recordkeeping function that will often be performed by the accounting department. Answer (b) is incorrect because most frequently the receiving department will inspect goods upon receipt. Answer (c) is incorrect because user groups or stores will authorize requisitions of goods. Keep in mind the principle of segregation of functions. Recordkeeping, authorization, and custodial functions should all be segregated.

70. (c) The requirement is to identify the **most** likely procedure an auditor would perform in obtaining an understanding of a manufacturing entity's internal control for inventory balances. Answer (c) is correct because a review of the entity's descriptions of inventory policies and procedures will help the auditor to obtain the necessary understanding about the design of relevant policies, procedures, and records, and whether they have been implemented by the entity. Answers (a) and (b) are incorrect because analyses of liquidity and turnover ratios are analytical procedures designed to identify cost variances that will help the auditor primarily to determine the nature, timing and extent of auditing procedures that will be used to obtain evidence for specific account balances or classes of transactions. Answer (d) is incorrect because test counts of inventory are generally obtained as a substantive procedure.

71. (d) The requirement is to identify the control that **most** likely would be used to maintain accurate inventory records. Answer (d) is correct because periodic inventory counts will assure that perpetual inventory records are accurate and, because employees will know that inventory differences are investigated, they will be less likely to steal any inventory. Answer (a) is incorrect because comparing the perpetual inventory records with current costs of items will reveal situations in which costs have changed, but is unlikely to help in the maintenance of accurate inventory records. Answer (b) is incorrect because while a just-in-time inventory ordering system may help assure that inventory records are accurate (as well as kept at low levels), such a system generally also requires periodic inventory counts to maintain accurate inventory records. Answer (c) is incorrect because matching requisitions, receiving reports, and purchase orders only helps assure that items received are paid for; the matching process does not assure accurate inventory records.

72. (d) The requirement is to determine a likely effect on the audit of inventory if the assessed level of control risk is high. Answer (d) is correct because a high assessed level of control risk may result in changing the timing of substantive tests to year-end rather than at an interim date. If the assessed level of control risk is low, the auditor could perform interim substantive tests and rely upon internal control to provide valid year-end records. However, because the assessed level of control risk is high, the controls cannot be relied upon. Also, the nature of substantive tests may change from less effective to more effective procedures (e.g., use of independent parties outside the entity rather than internal) and an increase in the extent of procedures (e.g., larger sample sizes). Answer (a) is incorrect because, as indicated, an auditor will generally seek a year-end count of inventory. Answer (b) is incorrect because gross profit tests will not in general have the required precision when control risk is high. Answer (c) is incorrect because tests of controls are likely to substantiate an auditor's view that control risk is high, and it is therefore unlikely that their performance will be cost-effective.

73. (c) The requirement is to identify the control which is **most** likely to address the completeness assertion for inventory.

Answer (c) is correct because by prenumbering receiving reports and by reconciling them with inventory records, one is able to test completeness by determining whether all receipts have been recorded. Answer (a) is incorrect because reconciling the subsidiary records with the work in process will only identify discrepancies between the records, it will not identify whether all transactions that should be in the inventory records are represented in the records. Answer (b) is incorrect because while the segregation of receiving from custody of finished goods is important, it less directly addresses completeness than does answer (a). Answer (d) is incorrect because separating the duties between the payroll department and inventory accounting personnel does not directly address completeness of inventory.

74. (c) The requirement is to determine the proper internal control for handling customer returns of defective merchandise. Answer (c) is correct because the receiving department can count the goods, and list them on a sales return notice to determine that all such returns are properly recorded. This serves as a control because the normal procedures of the receiving function include establishing the original accountability and recordkeeping for items received. Answers (a), (b), and (d) all represent functions not typically involved in the receiving function and thus involve a higher risk relating to establishing accountability.

75. (c) The requirement is to identify the effect on revenues, receivables, and inventory of inadequate controls over the invoicing function that allows goods to be shipped without being invoiced. Items shipped without invoicing will result in a situation in which the accounting department is unaware of the sale. Therefore, debits to accounts receivable and credits to sales will not be recorded, resulting in an understatement of both revenues and receivables. Similarly, because accounting is unaware of the sale, no entry to reduce inventory will be made, resulting in an overstatement of inventory.

76. (c) The requirement is to identify the question that an auditor would expect to find on the **production** cycle section of an internal control questionnaire. Answer (c) is correct because approved requisitions will help maintain control over raw materials released to be used in the production cycle. Answers (a), (b), and (d) are all incorrect because approval of vendors' invoices for payment, mailing of checks after signing, and comparing individual disbursements to totals all pertain more directly to the disbursement cycle.

77. (b) The requirement is to determine an objective of internal control for a production cycle in addition to providing assurance that transactions are properly executed and recorded. Answer (b) is correct because, in addition to providing assurance as to proper execution and recording, an objective for the production cycle (as well as other cycles) is the safeguarding of assets, here work in process and finished goods. Answers (a), (c), and (d) are incorrect because they represent detailed controls established to help achieve the overall objectives. They are all much more specific than the overall objectives.

78. (b) The requirement is to identify a purpose of vouching data for a sample of employees in a payroll register to approved

clock card data. Answer (b) is correct because the clock card data provides the auditor with evidence on whether employees worked the number of hours for which the payroll register indicates they were paid. Answer (a) is incorrect because clock card data often does not include authorized pay rates. Answer (c) is incorrect because the procedure does not directly address the segregation of duties since no information is provided concerning the distribution of the payroll. Answer (d) is incorrect because unclaimed payroll checks are not being analyzed.

79. (a) The requirement is to identify the control that **most** likely could help prevent employee payroll fraud. Answer (a) is correct because prompt notification of the payroll supervisor concerning terminations will lead to timely removal of terminated employees from the payroll. Accordingly, no payroll checks will be prepared for such terminated employees. Answer (b) is incorrect because unclaimed payroll checks should not be returned to the supervisors who might inappropriately cash them. Answer (c) is incorrect because since the payroll department is involved in recordkeeping, it should not approve salary rates. Answer (d) is incorrect because calculation of total hours by the payroll supervisor is unlikely to prevent employee payroll fraud.

80. (a) The requirement is to determine the **best** procedure for determining the effectiveness of an entity's controls relating to the existence or occurrence assertion for payroll transactions. Answer (a) is correct because proper segregation of duties between personnel and payroll disbursement eliminates many frauds in which "phantom" employees are being paid. Answer (b) is incorrect because accounting for the prenumbered payroll checks addresses completeness more directly than it does existence or occurrence. Answer (c) is incorrect because recomputing payroll deductions for employee fringe benefits, without additional analysis, provides only a very limited test of existence or occurrence. Answer (d) is incorrect because verifying the preparation of the monthly payroll account bank reconciliation is unlikely to provide evidence on the existence or occurrence assertion, although some possibility does exist if signatures on checks are analyzed in detail.

81. (c) The requirement is to identify the situation in which it is **most** likely that an auditor would assess control risk for payroll at a high level. Answer (c) is correct because the payroll department, which is essentially a recordkeeping function, should not also authorize payroll rate changes. Under strong internal control recordkeeping, authorization, and custody over assets should be segregated. Answer (a) is incorrect because examining authorization forms for new employees is consistent with the payroll department's recordkeeping function. Answer (b) is incorrect because comparing payroll registers with original batch transmittal data is a control relating to recordkeeping. Answer (d) is incorrect because while the actual hiring of employees is normally done in the personnel department, allowing the payroll department supervisor to hire subordinates, with proper approval, is not as inconsistent with payroll's recordkeeping function as is authorizing rate changes for all employees.

82. (c) The requirement is to identify the control **most** likely to prevent direct labor hours from being charged to manufacturing overhead. Answer (c) is correct because time tickets may be coded as to whether direct labor on various projects was involved. Accordingly, using time tickets will help identify direct labor costs. Answer (a) is incorrect because while periodic counts of work in process may provide a control over physical units of production, the counts will not in general provide assurance that direct labor hours are properly charged to the product rather than to manufacturing overhead. Answer (b) is incorrect because comparing daily journal entries with production orders will not in general identify costs that have been omitted from direct labor due to the level of aggregation of the entries. Answer (d) is incorrect because the reconciliation of work in process inventory with budgets will provide only very limited detection ability relating to the charging of direct labor to manufacturing overhead.

83. (a) The requirement is to determine the individual(s) who should distribute paychecks and have custody of unclaimed paychecks. Answer (a) is correct because these custody functions should not be performed by the payroll department which is a recordkeeping function. Under proper internal control recordkeeping, custody, and authorization of transactions should be segregated.

84. (c) If payment of wages were to be in cash, each employee receiving payment should be required to sign a receipt for the amount of pay received. Thus, there would be control over the total amount disbursed as well as amounts disbursed to each individual employee. Answer (a) is incorrect because if a signed receipt is not received from each employee paid, there would be no proof of payment. Even though the pay envelopes include both cash and a computation of net wages, the employees should have the opportunity to count the cash received before signing a payroll receipt. Answer (b) is incorrect because unclaimed pay envelopes should not be retained by the paymaster, but rather deposited in a bank account by the cashier. Answer (d) is incorrect because the wage payment will be made in cash and not by check. Accordingly, a receipt must be obtained for each cash payment.

85. (a) The requirement is to identify the purpose of segregating the duties of hiring personnel and of distributing payroll checks. Answer (a) is correct because the hiring of personnel is an authorization function while the distribution of checks is a custody function. Thus, in order to properly segregate authorization from custody, these duties should not be performed by the same individual. The combination of these two functions in the same position would create the possibility of the addition of a fictitious employee to the payroll and subsequent misappropriation of paychecks. Answer (b) is incorrect because the functions involved are not primarily operational or recordkeeping. Answer (c) is incorrect because the treasury function, and not the controllership function, will normally be responsible for distributing payroll checks. Answer (d) is incorrect because segregation of duties does not directly address administrative controls vs. internal accounting controls.

86. (c) The requirement is to determine the **best** method to minimize the opportunities for fraud for unclaimed cash in a **cash** payroll system. For a **cash** payroll the best control is to get the unclaimed cash out of the firm's physical control and into the bank. Answer (a) is incorrect because maintaining the accountability for cash which is in a safe-deposit box is difficult. Answers (b) and (d) are incorrect because the cash need not be kept by the firm.

87. (c) The requirement is to identify a reason why an auditor may observe the distribution of paychecks. Answer (c) is correct because an employee's presence to collect the paycheck provides evidence that the employee actually exists and is currently employed by the client. Answer (a) is incorrect because the distributions of payroll checks would not reveal whether payrate authorization is properly separated from the operating function. Answer (b) is incorrect because the paycheck distribution does not provide information on whether deductions from gross pay have been calculated properly. Answer (d) is incorrect because observation of the paycheck distribution process does not of itself provide assurance that the paychecks agree with the related payroll register and time cards.

88. (a) The requirement is to determine the department **most** likely to approve change in pay rates and deductions from employee salaries. Answer (a) is correct because the personnel department, which has the primary objective of planning, controlling and coordinating employees, will determine that proposed salary increases (often recommended by supervisors of employees) are consistent with the company's salary guidelines and will approve changes in deductions. Answers (b) and (c) are incorrect because the treasurer and controller will in general initiate the pay rate change process for only those employees within their departments and will not generally approve changes for employees outside their departments. Answer (d) is incorrect because the payroll functions is a recordkeeping function which will modify employee pay rates based on approved changes from personnel. Payroll should not have authority regarding pay rates and deductions.

89. (d) The requirement is to determine the **most** likely question that would be included on an internal control questionnaire for notes payable. Answer (d) is correct because companies frequently require that direct borrowings on notes payable be authorized by the board of directors; accordingly, auditors will determine whether proper policy has been followed. Answer (a) is incorrect because internal control questionnaires do not in general include questions on whether assets that collateralize notes payable are critically needed. Answer (b) is incorrect because the internal control questionnaire for disbursements is more likely to address the required authorized signatures on checks than will the internal control questionnaire for notes payable. Answer (c) is incorrect because while it is often good business practice to use proceeds from long-term notes to purchase noncurrent assets, this is not required and is not included on an internal control questionnaire.

90. (d) The requirement is to identify the **primary** responsibility of a bank acting as registrar for capital stock.

Answer (d) is correct because the primary responsibility of the stock registrar is to prevent any overissuance of stock, and thereby verify that the stock is issued properly. Answer (a) is incorrect because registrar will not in general determine that the dividend amounts are proper. Answer (b) is incorrect because the transfer agent will maintain records of total shares outstanding as well as detailed stockholder records, and carry out transfers of stock ownership. Answer (c) is incorrect because registrars do not perform the role described relating to mergers, acquisitions, and the sale of treasury stock.

91. (a) Canceled stock certificates should be defaced and attached to corresponding stubs as is done with voided checks. The objective of the control is to prevent reissuance. Answer (b) is incorrect because failure to deface permits reissuance. Answer (c) is incorrect because destruction of the certificates would preclude their control (i.e., their existence after defacing provides assurance that they cannot be reissued). If the certificates were destroyed, one or more might be reissued without any proof that such occurred. Answer (d) is incorrect because the Secretary of State has no interest in receiving defaced and canceled stock certificates.

92. (a) The requirement is to identify the reply which is **not** a control that is designed to protect investment securities. Answer (a) is correct because it is not a control since the custody of securities should be assigned to individuals who **do not** have accounting responsibility for securities; as with other assets, authorization, recordkeeping, and custody should be separated. Answer (b) is incorrect because securities should be properly controlled physically in order to prevent unauthorized usage. Answer (c) is incorrect because access to securities should ordinarily be vested in two individuals so as to assure their safekeeping. Answer (d) is incorrect because securities should be registered in the name of the owner.

93. (b) The requirement is to identify the **best** control for safeguarding marketable securities when an independent trust agent is not employed. Answer (b) is correct because requiring joint control over securities maintained in a safe-deposit box assures that, absent collusion, assets are safeguarded. Answer (a) is incorrect because a review of investment decisions by the investment committee will have a very limited effect on *safeguarding* marketable securities. Answer (c) is incorrect because the simple tracing of marketable securities from the subsidiary ledgers to the general ledger does not directly safeguard marketable securities since, for example, unrecorded transactions may occur. Answer (d) is incorrect because, even if the chairman of the board did verify marketable securities on the balance sheet date, the control will only be effective at that point in time.

94. (d) The requirement is to identify the **best** audit procedure when a weakness in internal control over reporting of retirements exists. Answer (d) is correct because selecting certain items of equipment from the accounting records and attempting to locate them will reveal situations in which the accounting records still have them recorded subsequent to their retirement. Answer (a) is incorrect because inspecting items that still exist is not likely to lead to discovery of unrecorded retirements. Answer (b) is incorrect because

depreciation may continue to be taken on equipment that has been retired, but not recorded. Answer (c) is incorrect because it is doubtful that such retirements have been reclassified as "other assets."

95. (d) The requirement is to identify the question that is **least** likely to be included on an internal control questionnaire concerning the initiation and execution of equipment transactions. Answer (d) is correct because procedures to monitor and properly restrict access to equipment do not relate directly to the initiation and execution of equipment transactions. Answer (a) is incorrect because requests for major repairs relate to initiation of a transaction which should be controlled. Answer (b) is incorrect because prenumbered purchase orders may be used to control all purchases, including purchases of equipment. Answer (c) is incorrect because the significant amounts of money involved with purchases of equipment suggest the need for the solicitation of competitive bids.

96. (d) The requirement is to identify the control that would be most effective in assuring that the proper custody of assets in the investing cycle is maintained. Answer (d) is correct because comparing recorded balances in the investment subsidiary ledger with physical counts will help assure that recorded assets are those over which the company has custody. This is an example of the control activity of comparison of assets with recorded accountability. Answer (a) is incorrect because internal control is improved when two individuals, not one, must be present for entry to the safe-deposit box. Answer (b) is incorrect because while the segregation of duties within the recordkeeping may in certain circumstances be desirable, it does not directly address custody over assets. Answer (c) is incorrect because only extremely major investments generally need be authorized by the board of directors.

97. (d) The requirement is to determine who should have responsibility for custody of short-term bearer bond investments and the submission of coupons for periodic collections of interest. The treasurer authorizes such transactions. Answer (a) is incorrect because the chief accountant, who is in charge of the recordkeeping function, should not also maintain custody of the bonds. Answer (b) is incorrect because the internal auditor should not be directly involved as such involvement would make an independent review of the system impossible. Answer (c) is incorrect because the cashier function is more directly involved with details such as endorsing, depositing, and maintaining records of cash receipts.

98. (b) The requirement is to identify the control that would be **most** likely to assist an entity in satisfying the completeness assertion related to long-term investments. Answer (b) is correct because completeness deals with whether all transactions are recorded, and the comparison of securities in the bank safe-deposit box with recorded investments may reveal securities which are in the safe-deposit box but are not recorded. Answer (a) is incorrect because verification of security registration helps establish the rights assertion not the completeness assertion. Answer (c) is incorrect because vouching the acquisition

of securities by comparing brokers' advices with canceled checks helps to establish the existence assertion not the completeness assertion. Answer (d) is incorrect because a comparison of the current market prices of recorded investments with brokers' advices addresses the valuation assertion not the completeness assertion.

99. (a) The requirement is to identify the **best** control for safeguarding marketable securities against loss. Answer (a) is correct because use of an independent trust company allows the effective separation of custody and recordkeeping for the securities. Answer (b) is incorrect because a verification of marketable securities at the balance sheet date may have only a limited effect on safeguarding the securities throughout the year. Answer (c) is incorrect because tracing all purchases and sales of marketable securities will not affect securities that have disappeared for which no entries have been made. Also, it is unlikely that an entity will rely upon the independent auditor in this manner. Answer (d) is incorrect because maintenance of control over custody by a member of the board of directors may provide less complete control than the use of an independent trust company.

100. (c) The requirement is to determine the appropriate combination of audit tests when there are numerous property and equipment transactions during the year and the auditor plans to assess control risk at a low level. Answer (c) is correct because, to justify an assessment of control risk at a low level, tests of controls will be required. This will allow auditors to perform only limited tests of current year property and equipment transactions. Answer (a) is incorrect because tests of controls will be performed to allow the auditor to perform limited, not extensive, tests of property and equipment balances at the end of the year. Answers (b) and (d) are incorrect because analytical procedures on either year-end balances or transactions will not justify a low assessed level of control risk.

101. (d) The requirement is to determine the type of fraud which is most difficult to detect. Answer (d), a fraud committed by the controller, is most difficult to detect because the controller is in control of the recordkeeping function and thus may be able to commit a fraud and then manipulate the accounting records so as to make its discovery unlikely. Answer (a) is incorrect because while a cashier may be able to embezzle funds, s/he will not have access to the accounting records and thus discovery of the embezzlement will be likely. Answer (b) is incorrect because a keypunch operator will not in general have access to assets. Answer (c) is incorrect because an internal auditor will not generally be able to manipulate the accounting records and generally has limited access to assets.

102. (c) Answer (c) is correct because weaknesses that were communicated in the past and not corrected must be recommunicated to management and those charged with governance. Answers (a), (b), and (d) are all accurate statements about audit requirements.

103. (c) The requirement is to identify the matter an auditor would **most** likely consider to be a material weakness to be communicated to those charged with governance. Answer

(c) is correct because ineffective oversight of financial reporting by those charged with governance is an indicator of a material weakness—AU-C 265. Answers (a), (b), and (d) are all incorrect because a failure to renegotiate unfavorable long-term purchase commitments, recurring operating losses, and plans to reduce ownership equity do not fall within the definition of a material weakness.

104. (c) The requirement is to identify the correct statement concerning significant deficiencies identified in an audit. Answer (c) is correct because an auditor may communicate significant deficiencies either during an audit or after the audit's completion. Answer (a) is incorrect because an auditor need not search for significant deficiencies. Answer (b) is incorrect because all significant deficiencies are not also material weaknesses. Answer (d) is incorrect because an auditor may not issue a written report that **no** significant deficiencies were noted during an audit.

105. (d) The requirement is to identify the statement that should be included in an auditor's letter on significant deficiencies. Answer (d) is correct because AU-C 265 indicates that such a letter to the audit committee should (1) indicate that the audit's purpose was to report on the financial statements and **not** to express an opinion on internal control, (2) include the definition of a significant deficiency, and (3) restrict distribution of the report.

106. (c) The requirement is to identify the correct statement concerning an auditor's required communication of significant deficiencies. Answer (c) is correct because distribution of an auditor's report on significant deficiencies should be restricted to management and the audit committee. Answer (a) is incorrect because lack of correction of a significant deficiency does not necessarily result in a scope limitation. Answer (b) is incorrect because tests of controls need not be performed relating to significant deficiencies. Answer (d) is incorrect because although timely communication of significant deficiencies may be important, depending upon the nature of the significant deficiency identified, the auditor may choose to communicate it either after the audit is concluded or during the course of the audit.

107. (d) The requirement is to identify the correct statement about significant deficiencies noted in an audit. Answer (d) is correct because the auditor should separately identify and communicate material weaknesses and significant deficiencies (AU-C 265). Answer (a) is incorrect because significant deficiencies are less severe than material weaknesses. Answer (b) is incorrect because the auditor is not obligated to search for significant deficiencies. Answer (c) is incorrect because such deficiencies should be recommunicated.

108. (b) The requirement is to determine the representation that should **not** be included in a report on internal control related matters noted in an audit. Answer (b) is correct because the auditors should not issue a report on internal control stating that no significant deficiencies were identified during the audit. Answer (a) is incorrect because significant deficiencies should be disclosed. Answer (c) is incorrect because an auditor may recommend corrective follow-up action. Answer (d) is incorrect because an auditor may disclose the fact that the

consideration of internal control would **not** necessarily disclose all significant deficiencies that exist.

109. (b) The requirement is to identify the correct statement regarding material weaknesses and significant deficiencies. Answer (b) is correct because a compensating control is a control that lessens the severity of a deficiency (AU-C 265). Answer (a) is incorrect because material weaknesses should be reported separately from significant deficiencies. Answer (c) is incorrect because while the auditor may choose to communicate material weakness and significant deficiencies immediately, the communication may occur at other times. Answer (d) is incorrect because significant deficiencies are less severe than material weaknesses.

110. (b) The requirement is to determine an auditor's responsibility after s/he has discovered and orally communicated information on a weakness in internal control to the client's senior management and those charged with corporate governance. Answer (b) is correct because the auditor, as outlined throughout AU-C 330, considers and documents his/her understanding of internal control to assist in planning and determining the proper nature, timing, and extent of substantive tests. Answer (a) is incorrect because no scope limitation is indicated although an internal control condition does exist. Similarly, answers (c) and (d) are incorrect because audit activities need not be suspended and the auditor need not withdraw from the engagement.

111. (a) The requirement is to identify the **most** likely information a CPA would obtain in assessing the competence of an internal auditor. Answer (a) is correct because in assessing competence, an internal auditor will consider the quality of working paper documentation as well as a variety of other factors outlined in AU-C 610. Answer (b) is incorrect because an organization's commitment to integrity and ethical values, while important, does not bear as directly upon internal auditor competence. Answers (c) and (d) are incorrect because the influence of management and the organizational level to which the internal auditor reports are factors used to assess internal auditor objectivity. AU-C 610 provides overall guidance on the use of internal auditors.

112. (d) The requirement is to determine whether the independent auditor may share responsibility with an entity's internal auditor for assessing inherent risk and control risk. AU-C 610 requires that judgments about inherent and control risk always be those of the independent auditor. It also requires that judgments about the materiality of misstatements, the sufficiency of tests performed, the valuation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the independent auditor. See AU-C 610 for information on the external auditor's consideration of the internal audit function.

113. (d) The work of internal auditors may affect the nature, timing and extent of the audit, including (1) procedures the auditor performs when obtaining an understanding of the entity's internal control, (2) procedures the auditor performs when assessing risk, and (3) substantive procedures the auditor performs.

114. (c) The requirement is to identify the circumstance in which an internal auditor's work would **most** likely affect the nature, timing, and extent of a CPA's auditing procedures. When considering the effect of the internal auditors' work, the CPA considers (1) the materiality of financial statement amounts, (2) the risk of material misstatement of the assertions, and (3) the degree of subjectivity involved in the evaluation of the audit evidence. Answer (c) is correct because the existence of fixed asset additions involves little subjectivity. Answers (a) and (b) are incorrect because the existence of contingencies and the valuation of intangible assets are subjective and the risk of misstatement may be high. Answer (d) is incorrect because the valuation of related-party transactions may be very subjective due to the lack of an "arm's-length" transaction.

115. (d) AU-C 610 states that internal auditors may assist the CPA in obtaining an understanding of internal control, in performing tests of controls, and in performing substantive tests.

116. (b) The requirement is to identify the type of information used by a CPA to assess the competence of internal auditors. Answer (b) is correct because, along with various other factors, AU-C 610 indicates that the CPA should obtain evidence on the educational background and professional certification of the internal auditors when considering competence. Answers (a) and (c) are incorrect because analysis of organizational level to which the internal auditors report and policies on relatives are considered when assessing internal auditor objectivity. Answer (d) is incorrect because access to sensitive records will not provide a CPA with information on competence.

117. (d) The requirement is to identify the **least** likely source of information to the CPA on an entity's internal auditor's competence and objectivity. Answer (d) is correct because analytical procedures do not ordinarily provide information on the internal auditor. See AU-C 520 for information on analytical procedures.

118. (a) The requirement is to identify the characteristics of an internal auditor which must be considered by an independent auditor who decides that the internal auditor's work might have a bearing on his/her procedures. Answer (a) is correct because independent auditors must consider internal auditor competence, objectivity, and work performance. Answer (b) is incorrect because an independent auditor is less concerned about internal auditor efficiency, although internal auditor experience will be considered in the assessment of competence. Answers (c) and (d), while partially correct, are less complete than answer (a).

119. (d) The requirement is to determine how a CPA should assess the objectivity of an internal auditor. Answer (d) is correct because when assessing the objectivity of an internal auditor the CPA should consider organizational status and policies for maintaining objectivity. Answers (a), (b), and (c) are all incorrect because evaluating the quality control program, and examining and testing an internal auditor's work all relate more directly to assessing internal auditor competence rather than to objectivity. See AU-C 610 for these and other factors considered when assessing internal auditor competence.

Multiple-Choice Questions (1–162)

A.1. Sufficient Appropriate Audit Evidence

- Which of the following is **not** an assertion relating to classes of transactions?
 - Accuracy.
 - Consistency.
 - Cutoff.
 - Occurrence.
- Which of the following is a general principle relating to the reliability of audit evidence?
 - Audit evidence obtained from indirect sources rather than directly is more reliable than evidence obtained directly by the auditor.
 - Audit evidence provided by copies is more reliable than that provided by facsimiles.
 - Audit evidence obtained from knowledgeable independent sources outside the client company is more reliable than audit evidence obtained from nonindependent sources.
 - Audit evidence provided by original documents is more reliable than audit evidence generated through a system of effective controls.
- Which of the following types of audit evidence is the **most** persuasive?
 - Prenumbered client purchase order forms.
 - Client work sheets supporting cost allocations.
 - Bank statements obtained from the client.
 - Client representation letter.
- Which of the following presumptions is correct about the reliability of audit evidence?
 - Information obtained indirectly from outside sources is the most reliable audit evidence.
 - To be reliable, audit evidence should be convincing rather than persuasive.
 - Reliability of audit evidence refers to the amount of corroborative evidence obtained.
 - Effective internal control provides more assurance about the reliability of audit evidence.
- Which of the following statements relating to the appropriateness of audit evidence is always true?
 - Audit evidence gathered by an auditor from outside an enterprise is reliable.
 - Accounting data developed under satisfactory conditions of internal control are more relevant than data developed under unsatisfactory internal control conditions.
 - Oral representations made by management are **not** valid evidence.
 - Evidence gathered by auditors must be both valid and relevant to be considered appropriate.

- Which of the following types of audit evidence is the **least** persuasive?
 - Prenumbered purchase order forms.
 - Bank statements obtained from the client.
 - Test counts of inventory performed by the auditor.
 - Correspondence from the client's attorney about litigation.

- In evaluating the reasonableness of an entity's accounting estimates, an auditor normally would be concerned about assumptions that are
 - Susceptible to bias.
 - Consistent with prior periods.
 - Insensitive to variations.
 - Similar to industry guidelines.

A.2. Types of Audit Evidence

- Which of the following is **not** a basic procedure used in an audit?
 - Risk assessment procedures.
 - Substantive procedures.
 - Tests of controls.
 - Tests of direct evidence.
- Which of the following procedures would an auditor ordinarily perform first in evaluating management's accounting estimates for reasonableness?
 - Develop independent expectations of management's estimates.
 - Consider the appropriateness of the key factors or assumptions used in preparing the estimates.
 - Test the calculations used by management in developing the estimates.
 - Obtain an understanding of how management developed its estimates.
- In evaluating the reasonableness of an accounting estimate, an auditor **most** likely would concentrate on key factors and assumptions that are
 - Consistent with prior periods.
 - Similar to industry guidelines.
 - Objective and **not** susceptible to bias.
 - Deviations from historical patterns.
- In evaluating an entity's accounting estimates, one of an auditor's objectives is to determine whether the estimates are
 - Not subject to bias.
 - Consistent with industry guidelines.
 - Based on objective assumptions.
 - Reasonable in the circumstances.

12. In testing the existence assertion for an asset, an auditor ordinarily works from the

- a. Financial statements to the potentially unrecorded items.
- b. Potentially unrecorded items to the financial statements.
- c. Accounting records to the supporting evidence.
- d. Supporting evidence to the accounting records.

13. A client uses a suspense account for unresolved questions whose final accounting has not been determined. If a balance remains in the suspense account at year-end, the auditor would be most concerned about

- a. Suspense debits that management believes will benefit future operations.
- b. Suspense debits that the auditor verifies will have realizable value to the client.
- c. Suspense credits that management believes should be classified as "Current liability."
- d. Suspense credits that the auditor determines to be customer deposits.

B.1.a. Analytical Procedures

14. Which of the following would **not** be considered an analytical procedure?

- a. Estimating payroll expense by multiplying the number of employees by the average hourly wage rate and the total hours worked.
- b. Projecting an error rate by comparing the results of a statistical sample with the actual population characteristics.
- c. Computing accounts receivable turnover by dividing credit sales by the average net receivables.
- d. Developing the expected current year sales based on the sales trend of the prior five years.

15. What type of analytical procedure would an auditor **most** likely use in developing relationships among balance sheet accounts when reviewing the financial statements of a nonpublic entity?

- a. Trend analysis.
- b. Regression analysis.
- c. Ratio analysis.
- d. Risk analysis.

16. An auditor may achieve audit objectives related to particular assertions by

- a. Performing analytical procedures.
- b. Adhering to a system of quality control.
- c. Preparing auditor working papers.
- d. Increasing the level of detection risk.

17. An entity's income statements were misstated due to the recording of journal entries that involved debits and credits to an unusual combination of expense and revenue accounts. The auditor **most** likely could have detected this fraudulent financial reporting by

- a. Tracing a sample of journal entries to the general ledger.
- b. Evaluating the effectiveness of internal control.
- c. Investigating the reconciliations between controlling accounts and subsidiary records.
- d. Performing analytical procedures designed to disclose differences from expectations.

18. Auditors try to identify predictable relationships when using analytical procedures. Relationships involving transactions from which of the following accounts **most** likely would yield the highest level of evidence?

- a. Accounts receivable.
- b. Interest expense.
- c. Accounts payable.
- d. Travel and entertainment expense.

19. Analytical procedures used in the overall review stage of an audit generally include

- a. Gathering evidence concerning account balances that have **not** changed from the prior year.
- b. Retesting control procedures that appeared to be ineffective during the assessment of control risk.
- c. Considering unusual or unexpected account balances that were **not** previously identified.
- d. Performing tests of transactions to corroborate management's financial statement assertions.

20. Which of the following tends to be **most** predictable for purposes of analytical procedures applied as substantive procedures?

- a. Relationships involving balance sheet accounts.
- b. Transactions subject to management discretion.
- c. Relationships involving income statement accounts.
- d. Data subject to audit testing in the prior year.

21. A basic premise underlying the application of analytical procedures is that

- a. The study of financial ratios is an acceptable alternative to the investigation of unusual fluctuations.
- b. Statistical tests of financial information may lead to the discovery of material misstatements in the financial statements.
- c. Plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary.
- d. These procedures **cannot** replace tests of balances and transactions.

22. For all audits of financial statements made in accordance with generally accepted auditing standards, the use of analytical procedures is required to some extent

	In the risk assessment stage	As a substantive procedure	Near-audit completion
a.	Yes	No	Yes
b.	No	Yes	No
c.	No	Yes	Yes
d.	Yes	No	No

23. An auditor's analytical procedures **most** likely would be facilitated if the entity

- Segregates obsolete inventory before the physical inventory count.
- Uses a standard cost system that produces variance reports.
- Corrects material weaknesses in internal control before the beginning of the audit.
- Develops its data from sources solely within the entity.

24. Analytical procedures performed near the end of an audit suggest that several accounts have unexpected relationships. The results of these procedures **most** likely would indicate that

- Irregularities exist among the relevant account balances.
- Internal control activities are **not** operating effectively.
- Additional tests of details are required.
- The communication with the audit committee should be revised.

25. Which of the following comparisons would an auditor **most** likely make in evaluating an entity's costs and expenses?

- The current year's accounts receivable with the prior year's accounts receivable.
- The current year's payroll expense with the prior year's payroll expense.
- The budgeted current year's sales with the prior year's sales.
- The budgeted current year's warranty expense with the current year's contingent liabilities.

26. To be effective, analytical procedures performed near the end of an audit engagement should be performed by

- The staff accountant who performed the substantive auditing procedures.
- The managing partner who has responsibility for all audit engagements at that practice office.
- A manager or partner who has a comprehensive knowledge of the client's business and industry.
- The CPA firm's quality control manager or partner who has responsibility for the firm's peer review program.

B.1.b. Tests of Details of Transactions, Balances, and Disclosures

27. Which of the following is the **best** example of a substantive procedure?

- Examining a sample of cash disbursements to test whether expenses have been properly approved.
- Confirmation of balances of accounts receivable.
- Comparison of signatures on checks to a list of authorized signers.
- Flowcharting of the client's cash receipts system.

28. The objective of tests of details of transactions performed as substantive procedures is to

- Comply with generally accepted auditing standards.
- Attain assurance about the reliability of the accounting system.
- Detect material misstatements in the financial statements.
- Evaluate whether management's policies and procedures operated effectively.

29. In the context of an audit of financial statements, substantive procedures are audit procedures that

- May be eliminated under certain conditions.
- Are designed to discover significant subsequent events.
- May be either tests of transactions, direct tests of financial balances, or analytical tests.
- Will increase proportionately with the auditor's reliance on internal control.

30. The auditor will **most** likely perform extensive tests for possible understatement of

- Revenues.
- Assets.
- Liabilities.
- Capital.

B.2. Specific Substantive Procedures

31. In determining whether transactions have been recorded, the direction of the audit testing should be from the

- General ledger balances.
- Adjusted trial balance.
- Original source documents.
- General journal entries.

B.3. Documentation

32. Which statement is correct concerning the deletion of audit documentation?

- Superseded audit documentation should always be deleted from the audit file.
- After the audit file has been completed, the auditor should not delete or discard audit documentation.
- Auditors should use professional skepticism in determining which audit documentation should be deleted.
- Audit documentation should never be deleted from the audit file.

33. Ignoring any particular legal or regulatory requirement, audit documentation should be retained

- a. A minimum of five years.
- b. As long as lead schedules have relevance to forthcoming audits.
- c. Until three years after the client selects another auditor.
- d. Working papers must be maintained indefinitely.

34. Which of the following pairs of accounts would an auditor **most** likely analyze on the same working paper?

- a. Notes receivable and interest income.
- b. Accrued interest receivable and accrued interest payable.
- c. Notes payable and notes receivable.
- d. Interest income and interest expense.

35. An auditor's working papers serve mainly to

- a. Provide the principal support for the auditor's report.
- b. Satisfy the auditor's responsibilities concerning the *Code of Professional Conduct*.
- c. Monitor the effectiveness of the CPA firm's quality control procedures.
- d. Document the level of independence maintained by the auditor.

36. The permanent file of an auditor's working papers generally would **not** include

- a. Bond indenture agreements.
- b. Lease agreements.
- c. Working trial balance.
- d. Flowchart of internal control.

37. An auditor ordinarily uses a working trial balance resembling the financial statements without footnotes, but containing columns for

- a. Cash flow increases and decreases.
- b. Audit objectives and assertions.
- c. Reclassifications and adjustments.
- d. Reconciliations and tick marks.

38. Which of the following is **least** likely to be a factor in the auditor's decision about the extent of the documentation of a particular audit area?

- a. The risk of material misstatement.
- b. The extent of the judgment involved in performing the procedures.
- c. The nature and extent of exceptions identified.
- d. Whether or not the client has an internal audit function.

39. Which of the following is required documentation in an audit in accordance with generally accepted auditing standards?

- a. A flowchart or narrative of the accounting system describing the recording and classification of transactions for financial reporting.
- b. The overall audit strategy and audit plan.

- c. A memo summarizing all major stakeholder groups.
- d. An internal control questionnaire identifying controls that assure specific objectives will be achieved.

40. Which of the following factors **most** likely would affect an auditor's judgment about the quantity, type, and content of the auditor's working papers?

- a. The assessed level of control risk.
- b. The likelihood of a review by a concurring (second) partner.
- c. The number of personnel assigned to the audit.
- d. The content of the management representation letter.

41. The audit working paper that reflects the major components of an amount reported in the financial statements is the

- a. Interbank transfer schedule.
- b. Carryforward schedule.
- c. Supporting schedule.
- d. Lead schedule.

42. Which documentation is required for an audit in accordance with generally accepted auditing standards?

- a. A flowchart or an internal control questionnaire that evaluates the effectiveness of the entity's controls.
- b. A client engagement letter that provides details of timing of each significant audit procedure and personnel performing that procedure.
- c. An indication in the working papers that the accounting records agree or reconcile with the financial statements.
- d. The basis for the auditor's conclusions when the assessed level of control risk is at the maximum level for all financial statement assertions.

43. No deletions of audit documentation are allowed after the

- a. Client's year-end.
- b. Documentation completion date.
- c. Last date of significant fieldwork.
- d. Report release date.

44. Under the requirements of the PCAOB, audit documentation must contain sufficient information to allow what type of auditor to understand the nature, timing, extent, and results of procedures performed?

- a. An experienced audit team member.
- b. An experienced auditor having no previous connection with the engagement.
- c. Any certified public accountant.
- d. An auditor qualified as a peer review specialist.

45. Audit documentation for audits performed under the requirements of the Public Company Accounting Oversight Board should be retained for

- a. The shorter of five years, or the period required by law.
- b. Seven years.
- c. The longer of seven years, or the period required by law.
- d. Indefinitely.

C.1. Evidence—Cash

46. Which of the following sets of information does an auditor usually confirm on one form?

- a. Accounts payable and purchase commitments.
- b. Cash in bank and collateral for loans.
- c. Inventory on consignment and contingent liabilities.
- d. Accounts receivable and accrued interest receivable.

47. The usefulness of the standard bank confirmation request may be limited because the bank employee who completes the form may

- a. Not believe that the bank is obligated to verify confidential information to a third party.

- b. Sign and return the form without inspecting the accuracy of the client's bank reconciliation.
- c. Not have access to the client's cutoff bank statement.
- d. Be unaware of all the financial relationships that the bank has with the client.

48. An auditor **most** likely would limit substantive audit tests of sales transactions when control risk is assessed as low for the occurrence assertion concerning sales transactions and the auditor has already gathered evidence supporting

- a. Opening and closing inventory balances.
- b. Cash receipts and accounts receivable.
- c. Shipping and receiving activities.
- d. Cutoffs of sales and purchases.

Items 49 and 50 are based on the following:

The information below was taken from the bank transfer schedule prepared during the audit of Fox Co.'s financial statements for the year ended December 31, 20X5. Assume all checks are dated and issued on December 30, 20X5.

Check no.	Bank accounts		Disbursement date		Receipt date	
	From	To	Per books	Per bank	Per books	Per bank
101	National	Federal	Dec. 30	Jan. 4	Dec. 30	Jan. 3
202	County	State	Jan. 3	Jan. 2	Dec. 30	Dec. 31
303	Federal	American	Dec. 31	Jan. 3	Jan. 2	Jan. 2
404	State	Republic	Jan. 2	Jan. 2	Jan. 2	Dec. 31

49. Which of the following checks might indicate kiting?

- a. #101 and #303.
- b. #202 and #404.
- c. #101 and #404.
- d. #202 and #303.

50. Which of the following checks illustrate deposits/transfers in transit at December 31, 20X5?

- a. #101 and #202.
- b. #101 and #303.
- c. #202 and #404.
- d. #303 and #404.

51. An auditor should trace bank transfers for the last part of the audit period and first part of the subsequent period to detect whether

- a. The cash receipts journal was held open for a few days after the year-end.
- b. The last checks recorded before the year-end were actually mailed by the year-end.
- c. Cash balances were overstated because of kiting.
- d. Any unusual payments to or receipts from related parties occurred.

52. To gather evidence regarding the balance per bank in a bank reconciliation, an auditor would examine all of the following **except**

- a. Cutoff bank statement.
- b. Year-end bank statement.
- c. Bank confirmation.
- d. General ledger.

53. Which of the following cash transfers results in a misstatement of cash at December 31, 2005?

Transfer	Bank Transfer Schedule			
	Disbursement		Receipt	
	Recorded in books	Paid by bank	Recorded in books	Received by bank
a.	12/31/X5	1/4/X6	12/31/X5	12/31/X5
b.	1/4/X6	1/5/X6	12/31/X5	1/4/X6
c.	12/31/X5	1/5/X6	12/31/X5	1/4/X6
d.	1/4/X6	1/11/X6	1/4/X6	1/4/X6

54. A cash shortage may be concealed by transporting funds from one location to another or by converting negotiable assets to cash. Because of this, which of the following is vital?

- a. Simultaneous confirmations.
- b. Simultaneous bank reconciliations.
- c. Simultaneous verification.
- d. Simultaneous surprise cash count.

55. The **primary** purpose of sending a standard confirmation request to financial institutions with which the client has done business during the year is to

- Detect kiting activities that may otherwise **not** be discovered.
- Corroborate information regarding deposit and loan balances.**
- Provide the data necessary to prepare a proof of cash.
- Request information about contingent liabilities and secured transactions.

56. An auditor observes the mailing of monthly statements to a client's customers and reviews evidence of follow-up on errors reported by the customers. This test of controls **most** likely is performed to support management's financial statement assertion(s) of

	Presentation and disclosure	Existence or occurrence
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

Items 57 and 58 are based on the following:

Miles Company
BANK TRANSFER SCHEDULE
December 31, 20X5

Check no.	Bank accounts		Amount	Date disbursed per		Date deposited per	
	From	To		Books	Bank	Books	Bank
2020	1st Natl.	Suburban	\$32,000	12/31	1/5♦	12/31	1/3▲
2021	1st Natl.	Capital	21,000	12/31	1/4♦	12/31	1/3▲
3217	2nd State	Suburban	6,700	1/3	1/5	1/3	1/6
0659	Midtown	Suburban	5,500	12/30	1/5♦	12/30	1/3▲

57. The tick mark ♦ **most** likely indicates that the amount was traced to the

- December cash disbursements journal.
- Outstanding check list of the applicable bank reconciliation.**
- January cash disbursements journal.
- Year-end bank confirmations.

58. The tick mark ▲ **most** likely indicates that the amount was traced to the

- Deposits in transit of the applicable bank reconciliation.**
- December cash receipts journal.
- January cash receipts journal.
- Year-end bank confirmations.

C.2. Evidence—Receivables

59. Which of the following statements is correct concerning the use of negative confirmation requests?

- Unreturned negative confirmation requests rarely provide significant explicit evidence.**
- Negative confirmation requests are effective when detection risk is low.
- Unreturned negative confirmation requests indicate that alternative procedures are necessary.
- Negative confirmation requests are effective when understatements of account balances are suspected.

60. When an auditor does **not** receive replies to positive requests for year-end accounts receivable confirmations, the auditor **most** likely would

- Inspect the allowance account to verify whether the accounts were subsequently written off.

- Increase the assessed level of detection risk for the valuation and completeness assertions.

- Ask the client to contact the customers to request that the confirmations be returned.**
- Increase the assessed level of inherent risk for the revenue cycle.

61. In confirming a client's accounts receivable in prior years, an auditor found that there were many differences between the recorded account balances and the confirmation replies. These differences, which were not misstatements, required substantial time to resolve. In defining the sampling unit for the current year's audit, the auditor **most** likely would choose

- Individual overdue balances.
- Individual invoices.**
- Small account balances.
- Large account balances.

62. Confirmation is **most** likely to be a relevant form of evidence with regard to assertions about accounts receivable when the auditor has concerns about the receivables'

- a. Valuation.
- b. Classification.
- c. Existence.
- d. Completeness.

63. An auditor should perform alternative procedures to substantiate the existence of accounts receivable when

- a. No reply to a positive confirmation request is received.
- b. No reply to a negative confirmation request is received.
- c. Collectibility of the receivables is in doubt.
- d. Pledging of the receivables is probable.

64. Which of the following procedures would an auditor **most** likely perform for year-end accounts receivable confirmations when the auditor did **not** receive replies to second requests?

- a. Review the cash receipts journal for the month prior to the year-end.
- b. Intensify the study of internal control concerning the revenue cycle.
- c. Increase the assessed level of detection risk for the existence assertion.
- d. Inspect the shipping records documenting the merchandise sold to the debtors.

65. In which of the following circumstances would the use of the negative form of accounts receivable confirmation **most** likely be justified?

- a. A substantial number of accounts may be in dispute and the accounts receivable balance arises from sales to a few major customers.
- b. A substantial number of accounts may be in dispute and the accounts receivable balance arises from sales to many customers with small balances.
- c. A small number of accounts may be in dispute and the accounts receivable balance arises from sales to a few major customers.
- d. A small number of accounts may be in dispute and the accounts receivable balance arises from sales to many customers with small balances.

66. To reduce the risks associated with accepting e-mail responses to requests for confirmation of accounts receivable, an auditor **most** likely would

- a. Request the senders to mail the original forms to the auditor.
- b. Examine subsequent cash receipts for the accounts in question.
- c. Consider the e-mail responses to the confirmations to be exceptions.
- d. Mail second requests to the e-mail respondents.

67. To reduce the risks associated with accepting fax responses to requests for confirmations of accounts receivable, an auditor **most** likely would

- a. Examine the shipping documents that provide evidence for the existence assertion.

b. Verify the sources and contents of the faxes in telephone calls to the senders.

c. Consider the faxes to be nonresponses and evaluate them as unadjusted differences.

d. Inspect the faxes for forgeries or alterations and consider them to be acceptable if none are noted.

68. In auditing accounts receivable, the negative form of confirmation request **most** likely would be used when

- a. The total recorded amount of accounts receivable is immaterial to the financial statements taken as a whole.
- b. Response rates in prior years to properly designed positive confirmation requests were inadequate.
- c. Recipients are likely to return positive confirmation requests without verifying the accuracy of the information.
- d. The combined assessed level of inherent risk and control risk relative to accounts receivable is low.

69. Under which of the following circumstances would the use of the blank form of confirmations of accounts receivable **most** likely be preferable to positive confirmations?

- a. The recipients are likely to sign the confirmations without devoting proper attention to them.
- b. Subsequent cash receipts are unusually difficult to verify.
- c. Analytical procedures indicate that few exceptions are expected.
- d. The combined assessed level of inherent risk and control risk is low.

70. In confirming accounts receivable, an auditor decided to confirm customers' account balances rather than individual invoices. Which of the following **most** likely would be included with the client's confirmation letter?

- a. An auditor-prepared letter explaining that a nonresponse may cause an inference that the account balance is correct.
- b. A client-prepared letter reminding the customer that a nonresponse will cause a second request to be sent.
- c. An auditor-prepared letter requesting the customer to supply missing and incorrect information directly to the auditor.
- d. A client-prepared statement of account showing the details of the customer's account balance.

71. Which of the following statements would an auditor **most** likely add to the negative form of confirmations of accounts receivable to encourage timely consideration by the recipients?

- a. "This is **not** a request for payment; remittances should **not** be sent to our auditors in the enclosed envelope."
- b. "Report any differences on the enclosed statement directly to our auditors; **no** reply is necessary if this amount agrees with your records."
- c. "If you do **not** report any differences within fifteen days, it will be assumed that this statement is correct."
- d. "The following invoices have been selected for confirmation and represent amounts that are overdue."

72. Which of the following strategies **most** likely could improve the response rate of the confirmation of accounts receivable?

- a. Including a list of items or invoices that constitute the account balance.
- b. Restricting the selection of accounts to be confirmed to those customers with relatively large balances.
- c. Requesting customers to respond to the confirmation requests directly to the auditor by fax or e-mail.
- d. Notifying the recipients that second requests will be mailed if they fail to respond in a timely manner.

C.3. Evidence—Inventory

73. An auditor **most** likely would make inquiries of production and sales personnel concerning possible obsolete or slow-moving inventory to support management's financial statement assertion of

- a. Valuation.
- b. Rights.
- c. Existence.
- d. Presentation.

74. While observing a client's annual physical inventory, an auditor recorded test counts for several items and noticed that certain test counts were higher than the recorded quantities in the client's perpetual records. This situation could be the result of the client's failure to record

- a. Purchase discounts.
- b. Purchase returns.
- c. Sales.
- d. Sales returns.

75. To gain assurance that all inventory items in a client's inventory listing schedule are valid, an auditor **most** likely would trace

- a. Inventory tags noted during the auditor's observation to items listed in the inventory listing schedule.
- b. Inventory tags noted during the auditor's observation to items listed in receiving reports and vendors' invoices.
- c. Items listed in the inventory listing schedule to inventory tags and the auditor's recorded count sheets.
- d. Items listed in receiving reports and vendors' invoices to the inventory listing schedule.

76. To measure how effectively an entity employs its resources, an auditor calculates inventory turnover by dividing average inventory into

- a. Net sales.
- b. Cost of goods sold.
- c. Operating income.
- d. Gross sales.

77. Which of the following auditing procedures **most** likely would provide assurance about a manufacturing entity's inventory valuation?

- a. Testing the entity's computation of standard overhead rates.
- b. Obtaining confirmation of inventories pledged under loan agreements.

- c. Reviewing shipping and receiving cutoff procedures for inventories.
- d. Tracing test counts to the entity's inventory listing.

78. A client maintains perpetual inventory records in both quantities and dollars. If the assessed level of control risk is high, an auditor would probably

- a. Increase the extent of tests of controls of the inventory cycle.
- b. Request the client to schedule the physical inventory count at the end of the year.
- c. Insist that the client perform physical counts of inventory items several times during the year.
- d. Apply gross profit tests to ascertain the reasonableness of the physical counts.

79. An auditor concluded that no excessive costs for idle plant were charged to inventory. This conclusion **most** likely related to the auditor's objective to obtain evidence about the financial statement assertions regarding inventory, including presentation and disclosure and

- a. Valuation.
- b. Completeness.
- c. Existence.
- d. Rights.

80. An auditor selected items for test counts while observing a client's physical inventory. The auditor then traced the test counts to the client's inventory listing. This procedure **most** likely obtained evidence concerning management's assertion of

- a. Rights.
- b. Completeness.
- c. Existence.
- d. Valuation.

81. An auditor **most** likely would analyze inventory turnover rates to obtain evidence concerning management's assertions about

- a. Existence.
- b. Rights.
- c. Presentation.
- d. Valuation.

82. An auditor usually examines receiving reports to support entries in the

- a. Voucher register and sales returns journal.
- b. Sales journal and sales returns journal.
- c. Voucher register and sales journal.
- d. Check register and sales journal.

83. When auditing inventories, an auditor would **least** likely verify that

- a. The financial statement presentation of inventories is appropriate.
- b. Damaged goods and obsolete items have been properly accounted for.
- c. All inventory owned by the client is on hand at the time of the count.
- d. The client has used proper inventory pricing.

C.4. Evidence—Investment Securities

84. An auditor who physically examines securities should insist that a client representative be present in order to

- Detect fraudulent securities.
- Lend authority to the auditor's directives.
- Acknowledge the receipt of securities returned.
- Coordinate the return of securities to the proper locations.

85. In establishing the existence and ownership of a long-term investment in the form of publicly traded stock, an auditor should inspect the securities or

- Correspond with the investee company to verify the number of shares owned.
- Inspect the audited financial statements of the investee company.
- Confirm the number of shares owned that are held by an independent custodian.
- Determine that the investment is carried at the lower of cost or market.

86. When an auditor is unable to inspect and count a client's investment securities until after the balance sheet date, the bank where the securities are held in a safe-deposit box should be asked to

- Verify any differences between the contents of the box and the balances in the client's subsidiary ledger.
- Provide a list of securities added and removed from the box between the balance sheet date and the security-count date.
- Confirm that there has been no access to the box between the balance sheet date and the security-count date.
- Count the securities in the box so the auditor will have an independent direct verification.

87. In testing long-term investments, an auditor ordinarily would use analytical procedures to ascertain the reasonableness of the

- Completeness of recorded investment income.
- Classification between current and noncurrent portfolios.
- Valuation of marketable equity securities.
- Existence of unrealized gains or losses in the portfolio.

C.5. Evidence—Property, Plant, and Equipment

88. Analysis of which account is **least** likely to reveal evidence relating to recorded retirement of equipment?

- Accumulated depreciation.
- Insurance expense.
- Property, plant, and equipment.
- Purchase returns and allowances.

89. Which of the following explanations **most** likely would satisfy an auditor who questions management about significant debits to the accumulated depreciation accounts?

- The estimated remaining useful lives of plant assets were revised upward.

b. Plant assets were retired during the year.

- The prior year's depreciation expense was erroneously understated.
- Overhead allocations were revised at year-end.

90. In testing for unrecorded retirements of equipment, an auditor **most** likely would

- Select items of equipment from the accounting records and then locate them during the plant tour.
- Compare depreciation journal entries with similar prior year entries in search of fully depreciated equipment.
- Inspect items of equipment observed during the plant tour and then trace them to the equipment subsidiary ledger.
- Scan the general journal for unusual equipment additions and excessive debits to repairs and maintenance expense.

91. An auditor analyzes repairs and maintenance accounts primarily to obtain evidence in support of the audit assertion that all

- Noncapitalizable expenditures for repairs and maintenance have been recorded in the proper period.
- Expenditures for property and equipment have been recorded in the proper period.
- Noncapitalizable expenditures for repairs and maintenance have been properly charged to expense.
- Expenditures for property and equipment have not been charged to expense.

92. The auditor is **most** likely to seek information from the plant manager with respect to the

- Adequacy of the provision for uncollectible accounts.
- Appropriateness of physical inventory observation procedures.
- Existence of obsolete machinery.
- Deferral of procurement of certain necessary insurance coverage.

93. Treetop Corporation acquired a building and arranged mortgage financing during the year. Verification of the related mortgage acquisition costs would be **least** likely to include an examination of the related

- Deed.
- Canceled checks.
- Closing statement.
- Interest expense.

94. In testing plant and equipment balances, an auditor may inspect new additions listed on the analysis of plant and equipment. This procedure is designed to obtain evidence concerning management's assertions of

	Existence or occurrence	Presentation and disclosure
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

C.6. Evidence—Prepaid Assets

95. In auditing intangible assets, an auditor **most** likely would review or recompute amortization and determine whether the amortization period is reasonable in support of management's financial statement assertion of

- a. Valuation or allocation.
- b. Existence or occurrence.
- c. Completeness.
- d. Rights and obligations.

96. When auditing prepaid insurance, an auditor discovers that the original insurance policy on plant equipment is not available for inspection. The policy's absence **most** likely indicates the possibility of a(n)

- a. Insurance premium due but **not** recorded.
- b. Deficiency in the coinsurance provision.
- c. Lien on the plant equipment.
- d. Understatement of insurance expense.

C.7. Evidence—Payables (Current)

97. Which of the following procedures would an auditor **most** likely perform in searching for unrecorded liabilities?

- a. Trace a sample of accounts payable entries recorded just before year-end to the unmatched receiving report file.
- b. Compare a sample of purchase orders issued just after year-end with the year-end accounts payable trial balance.
- c. Vouch a sample of cash disbursements recorded just after year-end to receiving reports and vendor invoices.
- d. Scan the cash disbursements entries recorded just before year-end for indications of unusual transactions.

98. When using confirmations to provide evidence about the completeness assertion for accounts payable, the appropriate population **most** likely would be

- a. Vendors with whom the entity has previously done business.
- b. Amounts recorded in the accounts payable subsidiary ledger.
- c. Payees of checks drawn in the month after the year-end.
- d. Invoices filed in the entity's open invoice file.

99. Auditor confirmation of accounts payable balances at the balance sheet date may be unnecessary because

- a. This is a duplication of cutoff tests.
- b. Accounts payable balances at the balance sheet date may not be paid before the audit is completed.
- c. Correspondence with the audit client's attorney will reveal all legal action by vendors for nonpayment.
- d. There is likely to be other reliable external evidence to support the balances.

100. Which of the following is a substantive procedure that an auditor **most** likely would perform to verify the existence and valuation of recorded accounts payable?

- a. Investigating the open purchase order file to ascertain that prenumbered purchase orders are used and accounted for.

b. Receiving the client's mail, unopened, for a reasonable period of time after the year-end to search for unrecorded vendors' invoices.

c. Vouching selected entries in the accounts payable subsidiary ledger to purchase orders and receiving reports.

d. Confirming accounts payable balances with known suppliers who have zero balances.

101. In auditing accounts payable, an auditor's procedures **most** likely would focus primarily on management's assertion of

- a. Existence.
- b. Presentation and disclosure.
- c. Completeness.
- d. Valuation.

C.8. Evidence—Long-Term Debt

102. When a CPA observes that the recorded interest expense seems to be excessive in relation to the balance in the bonds payable account, the CPA might suspect that

- a. Discount on bonds payable is understated.
- b. Bonds payable are understated.
- c. Bonds payable are overstated.
- d. Premium on bonds payable is overstated.

103. An auditor **most** likely would inspect loan agreements under which an entity's inventories are pledged to support management's financial statement assertion of

- a. Presentation and disclosure.
- b. Valuation or allocation.
- c. Existence or occurrence.
- d. Completeness.

104. In auditing long-term bonds payable, an auditor **most** likely would

- a. Perform analytical procedures on the bond premium and discount accounts.
- b. Examine documentation of assets purchased with bond proceeds for liens.
- c. Compare interest expense with the bond payable amount for reasonableness.
- d. Confirm the existence of individual bond holders at year-end.

105. The auditor can **best** verify a client's bond sinking fund transactions and year-end balance by

- a. Confirmation with individual holders of retired bonds.
- b. Confirmation with the bond trustee.
- c. Recomputation of interest expense, interest payable, and amortization of bond discount or premium.
- d. Examination and count of the bonds retired during the year.

C.9. Evidence—Owners' Equity

106. An auditor usually obtains evidence of stockholders' equity transactions by reviewing the entity's

- a. Minutes of board of directors meetings.
- b. Transfer agent's records.

- c. Canceled stock certificates.
- d. Treasury stock certificate book.

107. In performing tests concerning the granting of stock options, an auditor should

- a. Confirm the transaction with the Secretary of State in the state of incorporation.
- b. Verify the existence of option holders in the entity's payroll records or stock ledgers.
- c. Determine that sufficient treasury stock is available to cover any new stock issued.
- d. Trace the authorization for the transaction to a vote of the board of directors.

108. During an audit of an entity's stockholders' equity accounts, the auditor determines whether there are restrictions on retained earnings resulting from loans, agreements, or state law. This audit procedure **most** likely is intended to verify management's assertion of

- a. Existence or occurrence.
- b. Completeness.
- c. Valuation or allocation.
- d. Presentation and disclosure.

109. When a client company does **not** maintain its own stock records, the auditor should obtain written confirmation from the transfer agent and registrar concerning

- a. Restrictions on the payment of dividends.
- b. The number of shares issued and outstanding.
- c. Guarantees of preferred stock liquidation value.
- d. The number of shares subject to agreements to repurchase.

110. An audit plan for the examination of the retained earnings account should include a step that requires verification of the

- a. Market value used to charge retained earnings to account for a two-for-one stock split.
- b. Approval of the adjustment to the beginning balance as a result of a write-down of an account receivable.
- c. Authorization for both cash and stock dividends.
- d. Gain or loss resulting from disposition of treasury shares.

111. An auditor usually tests the reasonableness of dividend income from investments in publicly held companies by computing the amounts that should have been received by referring to

- a. Dividend record books produced by investment advisory services.
- b. Stock indentures published by corporate transfer agents.
- c. Stock ledgers maintained by independent registrars.
- d. Annual audited financial statements issued by the investee companies.

C.10. Revenue

112. The **most** likely risk involved with a bill and hold transaction at year-end is a(n)

- a. Accrued liability may be overstated as of year-end.
- b. Buyer may have made an absolute purchase commitment.

c. Sale may inappropriately have been recorded as of year-end.

- d. Buyer may have assumed the risk and reward of the purchased product.

113. Which of the following accounts is the practice of "channel stuffing" for sales **most** likely to **most** directly affect, and thereby result in additional audit procedures?

- a. Accrued liabilities.
- b. Allowance for sales returns.
- c. Cash.
- d. Marketable investments.

C.11. Expenses

114. When control risk is assessed as low for assertions related to payroll, substantive procedures of payroll balances **most** likely would be limited to applying analytical procedures and

- a. Observing the distribution of paychecks.
- b. Footing and crossfooting the payroll register.
- c. Inspecting payroll tax returns.
- d. Recalculating payroll accruals.

115. Which of the following circumstances **most** likely would cause an auditor to suspect an employee payroll fraud scheme?

- a. There are significant unexplained variances between standard and actual labor cost.
- b. Payroll checks are disbursed by the same employee each payday.
- c. Employee time cards are approved by individual departmental supervisors.
- d. A separate payroll bank account is maintained on an imprest basis.

116. In auditing payroll, an auditor **most** likely would

- a. Verify that checks representing unclaimed wages are mailed.
- b. Trace individual employee deductions to entity journal entries.
- c. Observe entity employees during a payroll distribution.
- d. Compare payroll costs with entity standards or budgets.

117. An auditor **most** likely would perform substantive procedures of details on payroll transactions and balances when

- a. Cutoff tests indicate a substantial amount of accrued payroll expense.
- b. The assessed level of control risk relative to payroll transactions is low.
- c. Analytical procedures indicate unusual fluctuations in recurring payroll entries.
- d. Accrued payroll expense consists primarily of unpaid commissions.

118. Recorded entries in which of the following accounts are **most** likely to relate to the property, plant, and equipment completeness assertion?

- a. Allowance for doubtful accounts.
- b. Marketable securities.

- c. Sales.
- d. Repairs and maintenance expense.

C.12. Client Representation Letters

119. For which of the following matters should an auditor obtain written management representations?

- a. Management's cost-benefit justifications for **not** correcting internal control weaknesses.
- b. Management's knowledge of future plans that may affect the price of the entity's stock.
- c. Management's compliance with contractual agreements that may affect the financial statements.
- d. Management's acknowledgment of its responsibility for employees' violations of laws.

120. To which of the following matters would materiality limits **not** apply in obtaining written management representations?

- a. The availability of minutes of stockholders' and directors' meetings.
- b. Losses from purchase commitments at prices in excess of market value.
- c. The disclosure of compensating balance arrangements involving related parties.
- d. Reductions of obsolete inventory to net realizable value.

121. The date of the management representation letter should coincide with the date of the

- a. Balance sheet.
- b. Latest interim financial information.
- c. Auditor's report.
- d. Latest related-party transaction.

122. Which of the following matters would an auditor **most** likely include in a management representation letter?

- a. Communications with the audit committee concerning weaknesses in internal control.
- b. The completeness and availability of minutes of stockholders' and directors' meetings.
- c. Plans to acquire or merge with other entities in the subsequent year.
- d. Management's acknowledgment of its responsibility for the detection of employee fraud.

123. The current chief executive and financial officers have only been employed by ABC Company for the past five months of year 2. ABC Company is presenting comparative financial statements on Years 1 and 2, both of which were audited by William Jones, CPA. For which year(s) should Jones obtain written representations from these two individuals?

	Year 1	Year 2
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

124. Which of the following statements ordinarily is included among the written client representations obtained by the auditor?

- a. Compensating balances and other arrangements involving restrictions on cash balances have been disclosed.
- b. Management acknowledges responsibility for illegal actions committed by employees.
- c. Sufficient audit evidence has been made available to permit the issuance of an unqualified opinion.
- d. Management acknowledges that there are **no** material weaknesses in the internal control.

125. When considering the use of management's written representations as audit evidence about the completeness assertion, an auditor should understand that such representations

- a. Complement, but do **not** replace, substantive procedures designed to support the assertion.
- b. Constitute sufficient evidence to support the assertion when considered in combination with reliance on internal control.
- c. Are **not** part of the audit evidence considered to support the assertion.
- d. Replace reliance on internal control as evidence to support the assertion.

126. A written representation from a client's management which, among other matters, acknowledges responsibility for the fair presentation of financial statements, should normally be signed by the

- a. Chief executive officer and the chief financial officer.
- b. Chief financial officer and the chairman of the board of directors.
- c. Chairman of the audit committee of the board of directors.
- d. Chief executive officer, the chairman of the board of directors, and the client's lawyer.

127. A limitation on the scope of the auditor's examination sufficient to preclude an unqualified opinion will always result when management

- a. Prevents the auditor from reviewing the working papers of the predecessor auditor.
- b. Engages the auditor after the year-end physical inventory count is completed.
- c. Fails to correct a significant deficiency of internal control that had been identified during the prior year's audit.
- d. Refuses to furnish a management representation letter to the auditor.

128. A purpose of a management representation letter is to reduce

- a. Audit risk to an aggregate level of misstatement that could be considered material.
- b. An auditor's responsibility to detect material misstatements only to the extent that the letter is relied on.
- c. The possibility of a misunderstanding concerning management's responsibility for the financial statements.
- d. The scope of an auditor's procedures concerning related-party transactions and subsequent events.

129. “There have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.” The foregoing passage is **most** likely from a

- a. Report on internal control.
- b. Special report.
- c. Management representation letter.
- d. Letter for underwriters.

C.13. Loss Contingencies and Inquiry of a Client’s Lawyer

130. A lawyer’s response to an auditor’s inquiry concerning litigation, claims, and assessments may be limited to matters that are considered individually or collectively material to the client’s financial statements. Which parties should reach an understanding on the limits of materiality for this purpose?

- a. The auditor and the client’s management.
- b. The client’s audit committee and the lawyer.
- c. The client’s management and the lawyer.
- d. The lawyer and the auditor.

131. The refusal of a client’s attorney to provide information requested in an inquiry letter generally is considered

- a. Grounds for an adverse opinion.
- b. A limitation on the scope of the audit.
- c. Reason to withdraw from the engagement.
- d. Equivalent to a significant deficiency.

132. Which of the following is an audit procedure that an auditor **most** likely would perform concerning litigation, claims, and assessments?

- a. Request the client’s lawyer to evaluate whether the client’s pending litigation, claims, and assessments indicate a going concern problem.
- b. Examine the legal documents in the client’s lawyer’s possession concerning litigation, claims, and assessments to which the lawyer has devoted substantive attention.
- c. Discuss with management its policies and procedures adopted for evaluating and accounting for litigation, claims, and assessments.
- d. Confirm directly with the client’s lawyer that all litigation, claims, and assessments have been recorded or disclosed in the financial statements.

133. The **primary** reason an auditor requests letters of inquiry be sent to a client’s attorneys is to provide the auditor with

- a. The probable outcome of asserted claims and pending or threatened litigation.
- b. Corroboration of the information furnished by management about litigation, claims, and assessments.
- c. The attorneys’ opinions of the client’s historical experiences in recent similar litigation.

- d. A description and evaluation of litigation, claims, and assessments that existed at the balance sheet date.

134. Which of the following is **not** an audit procedure that the independent auditor would perform concerning litigation, claims, and assessments?

- a. Obtain assurance from management that it has disclosed all unasserted claims that the lawyer has advised are probable of assertion and must be disclosed.
- b. Confirm directly with the client’s lawyer that all claims have been recorded in the financial statements.
- c. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- d. Obtain from management a description and evaluation of litigation, claims, and assessments existing at the balance sheet date.

135. The scope of an audit is **not** restricted when an attorney’s response to an auditor as a result of a client’s letter of audit inquiry limits the response to

- a. Matters to which the attorney has given substantive attention in the form of legal representation.
- b. An evaluation of the likelihood of an unfavorable outcome of the matters disclosed by the entity.
- c. The attorney’s opinion of the entity’s historical experience in recent similar litigation.
- d. The probable outcome of asserted claims and pending or threatened litigation.

136. A CPA has received an attorney’s letter in which no significant disagreements with the client’s assessments of contingent liabilities were noted. The resignation of the client’s lawyer shortly after receipt of the letter should alert the auditor that

- a. Undisclosed unasserted claims may have arisen.
- b. The attorney was unable to form a conclusion with respect to the significance of litigation, claims, and assessments.
- c. The auditor must begin a completely new examination of contingent liabilities.
- d. An adverse opinion will be necessary.

137. Which of the following statements extracted from a client’s lawyer’s letter concerning litigation, claims, and assessments **most** likely would cause the auditor to request clarification?

- a. “I believe that the possible liability to the company is nominal in amount.”
- b. “I believe that the action can be settled for less than the damages claimed.”
- c. “I believe that the plaintiff’s case against the company is without merit.”
- d. “I believe that the company will be able to defend this action successfully.”

C.14. Fair Values

138. When auditing the fair value of an asset or liability, valuation issues ordinarily arise at the point of

	Initial recording	Subsequent to initial recording
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

139. Which of the following is **least** likely to be an approach followed when auditing the fair values of assets and liabilities?

- a. Review and test management's process of valuation.
- b. Confirm valuations with audit committee members.
- c. Independently develop an estimate of the value of the account.
- d. Review subsequent events relating to the account.

C.15. Related-Party Transactions

140. Which of the following auditing procedures **most** likely would assist an auditor in identifying related-party transactions?

- a. Inspecting correspondence with lawyers for evidence of unreported contingent liabilities.
- b. Vouching accounting records for recurring transactions recorded just after the balance sheet date.
- c. Reviewing confirmations of loans receivable and payable for indications of guarantees.
- d. Performing analytical procedures for indications of possible financial difficulties.

141. After determining that a related-party transaction has, in fact, occurred, an auditor should

- a. Add a separate paragraph to the auditor's standard report to explain the transaction.
- b. Perform analytical procedures to verify whether similar transactions occurred, but were **not** recorded.
- c. Obtain an understanding of the business purpose of the transaction.
- d. Substantiate that the transaction was consummated on terms equivalent to an arm's-length transaction.

142. When auditing related-party transactions, an auditor places **primary** emphasis on

- a. Ascertaining the rights and obligations of the related parties.
- b. Confirming the existence of the related parties.
- c. Verifying the valuation of the related-party transactions.
- d. Evaluating the disclosure of the related-party transactions.

143. Which of the following statements is correct concerning related-party transactions?

- a. In the absence of evidence to the contrary, related-party transactions should be assumed to be outside the ordinary course of business.

- b. An auditor should determine whether a particular transaction would have occurred if the parties had **not** been related.
- c. An auditor should substantiate that related-party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions.
- d. The audit procedures directed toward identifying related-party transactions should include considering whether transactions are occurring, but are **not** being given proper accounting recognition.

144. An auditor **most** likely would modify an unqualified opinion if the entity's financial statements include a footnote on related-party transactions

- a. Disclosing loans to related parties at interest rates significantly below prevailing market rates.
- b. Describing an exchange of real estate for similar property in a nonmonetary related-party transaction.
- c. Stating that a particular related-party transaction occurred on terms equivalent to those that would have prevailed in an arm's-length transaction.
- d. Presenting the dollar volume of related-party transactions and the effects of any change in the method of establishing terms from prior periods.

C.16. Subsequent Events and Subsequent Discovery of Facts Existing at the Date of the Audit Report

145. Which of the following procedures would an auditor **most** likely perform in obtaining evidence about subsequent events?

- a. Determine that changes in employee pay rates after year-end were properly authorized.
- b. Recompute depreciation charges for plant assets sold after year-end.
- c. Inquire about payroll checks that were recorded before year-end but cashed after year-end.
- d. Investigate changes in long-term debt occurring after year-end.

146. Which of the following events occurring after the issuance of an auditor's report **most** likely would cause the auditor to make further inquiries about the previously issued financial statements?

- a. An uninsured natural disaster occurs that may affect the entity's ability to continue as a going concern.
- b. A contingency is resolved that had been disclosed in the audited financial statements.
- c. New information is discovered concerning undisclosed lease transactions of the audited period.
- d. A subsidiary is sold that accounts for 25% of the entity's consolidated net income.

147. Zero Corp. suffered a loss that would have a material effect on its financial statements on an uncollectible trade account receivable due to a customer's bankruptcy. This occurred suddenly due to a natural disaster ten days after Zero's balance sheet date, but one month before the issuance of the financial statements and the auditor's report. Under these circumstances,

	The financial statements should be adjusted	The event requires financial statement disclosure, but no adjustment	The auditor's report should be modified for a lack of consistency
a.	Yes	No	No
b.	Yes	No	Yes
c.	No	Yes	Yes
d.	No	Yes	No

148. After an audit report containing an unqualified opinion on a nonissuer (nonpublic) client's financial statements was issued, the client decided to sell the shares of a subsidiary that accounts for 30% of its revenue and 25% of its net income. The auditor should

- Determine whether the information is reliable and, if determined to be reliable, request that revised financial statements be issued.
- Notify the entity that the auditor's report may **no** longer be associated with the financial statements.
- Describe the effects of this subsequently discovered information in a communication with persons known to be relying on the financial statements.
- Take **no** action because the auditor has **no** obligation to make any further inquiries.

149. A client acquired 25% of its outstanding capital stock after year-end and prior to completion of the auditor's fieldwork. The auditor should

- Advise management to adjust the balance sheet to reflect the acquisition.
- Issue pro forma financial statements giving effect to the acquisition as if it had occurred at year-end.
- Advise management to disclose the acquisition in the notes to the financial statements.
- Disclose the acquisition in the opinion paragraph of the auditor's report.

150. Which of the following procedures would an auditor **most** likely perform to obtain evidence about the occurrence of subsequent events?

- Confirming a sample of material accounts receivable established after year-end.
- Comparing the financial statements being reported on with those of the prior period.
- Investigating personnel changes in the accounting department occurring after year-end.
- Inquiring as to whether any unusual adjustments were made after year-end.

151. Which of the following procedures should an auditor generally perform regarding subsequent events?

- Compare the latest available interim financial statements with the financial statements being audited.
- Send second requests to the client's customers who failed to respond to initial accounts receivable confirmation requests.
- Communicate material weaknesses in internal control to the client's audit committee.
- Review the cutoff bank statements for several months after the year-end.

C.17. Omitted Procedures Discovered after the Report Date

152. On February 25, a CPA issued an auditor's report expressing an unqualified opinion on financial statements for the year ended January 31. On March 2, the CPA learned that on February 11, the entity incurred a material loss on an uncollectible trade receivable as a result of the deteriorating financial condition of the entity's principal customer that led to the customer's bankruptcy. Management then refused to adjust the financial statements for this subsequent event. The CPA determined that the information is reliable and that there are creditors currently relying on the financial statements. The CPA's next course of action **most** likely would be to

- Notify the entity's creditors that the financial statements and the related auditor's report should **no** longer be relied on.
- Notify each member of the entity's board of directors about management's refusal to adjust the financial statements.
- Issue revised financial statements and distribute them to each creditor known to be relying on the financial statements.
- Issue a revised auditor's report and distribute it to each creditor known to be relying on the financial statements.

153. An auditor is considering whether the omission of a substantive procedure considered necessary at the time of an audit may impair the auditor's present ability to support the previously expressed opinion. The auditor need **not** apply the omitted procedure if the

- Financial statements and auditor's report were not distributed beyond management and the board of directors.
- Auditor's previously expressed opinion was qualified because of a departure from GAAP.
- Results of other procedures that were applied tend to compensate for the procedure omitted.
- Omission is due to unreasonable delays by client personnel in providing data on a timely basis.

154. On March 15, 20X2, Kent, CPA, issued an unqualified opinion on a client's audited financial statements for the year ended December 31, 20X1. On May 4, 20X2, Kent's internal inspection program disclosed that engagement personnel failed to observe the client's physical inventory. Omission of this procedure impairs Kent's present ability to support the unqualified opinion. If the stockholders are currently relying on the opinion, Kent should first

- Advise management to disclose to the stockholders that Kent's unqualified opinion should **not** be relied on.
- Undertake to apply alternative procedures that would provide a satisfactory basis for the unqualified opinion.
- Reissue the auditor's report and add an explanatory paragraph describing the departure from generally accepted auditing standards.

- d. Compensate for the omitted procedure by performing tests of controls to reduce audit risk to a sufficiently low level.

155. Six months after issuing an unqualified opinion on audited financial statements, an auditor discovered that the engagement personnel failed to confirm several of the client's material accounts receivable balances. The auditor should first

- a. Request the permission of the client to undertake the confirmation of accounts receivable.
- b. Perform alternative procedures to provide a satisfactory basis for the unqualified opinion.
- c. Assess the importance of the omitted procedures to the auditor's ability to support the previously expressed opinion.
- d. Inquire whether there are persons currently relying, or likely to rely, on the unqualified opinion.

C.18. Audit of Statement of Cash Flows

156. Which of the following procedures would an auditor most likely perform in auditing the statement of cash flows?

- a. Compare the amounts included in the statement of cash flows to similar amounts in the prior year's statement of cash flows.
- b. Reconcile the cutoff bank statements to verify the accuracy of the year-end bank balances.
- c. Vouch all bank transfers for the last week of the year and first week of the subsequent year.
- d. Reconcile the amounts included in the statement of cash flows to the other financial statements' balances and amounts.

D. Completing the Audit

157. Which of the following procedures is **least** likely to be performed before the balance sheet date?

- a. Testing of internal control over cash.
- b. Confirmation of receivables.
- c. Search for unrecorded liabilities.
- d. Observation of inventory.

158. Which of the following **most** likely would be detected by an auditor's review of a client's sales cutoff?

- a. Shipments lacking sales invoices and shipping documents.
- b. Excessive write-offs of accounts receivable.

c. Unrecorded sales at year-end.

- d. Lapping of year-end accounts receivable.

159. Cutoff tests designed to detect credit sales made before the end of the year that have been recorded in the subsequent year provide assurance about management's assertion of

- a. Presentation.
- b. Completeness.
- c. Rights.
- d. Existence.

160. Which of the following procedures would an auditor **most** likely perform during an audit engagement's overall review stage in formulating an opinion on an entity's financial statements?

- a. Obtain assurance from the entity's attorney that all material litigation has been disclosed in the financial statements.
- b. Verify the clerical accuracy of the entity's proof of cash and its bank cutoff statement.
- c. Determine whether inadequate provisions for the safeguarding of assets have been corrected.
- d. Consider whether the results of audit procedures affect the assessment of the risk of material misstatement due to fraud.

E. Other Related Topics

161. Operational auditing is primarily oriented toward

- a. Future improvements to accomplish the goals of management.
- b. The accuracy of data reflected in management's financial records.
- c. The verification that a company's financial statements are fairly presented.
- d. Past protection provided by existing internal control.

162. A typical objective of an operational audit is to determine whether an entity's

- a. Internal control is adequately operating as designed.
- b. Operational information is in accordance with generally accepted governmental auditing standards.
- c. Financial statements present fairly the results of operations.
- d. Specific operating units are functioning efficiently and effectively.

Multiple-Choice Answers and Explanations

Answers

1. b	—	—	31. c	—	—	61. b	—	—	91. d	—	—	121. c	—	—	151. a	—	—
2. c	—	—	32. b	—	—	62. c	—	—	92. c	—	—	122. b	—	—	152. b	—	—
3. c	—	—	33. a	—	—	63. a	—	—	93. a	—	—	123. d	—	—	153. c	—	—
4. d	—	—	34. a	—	—	64. d	—	—	94. b	—	—	124. a	—	—	154. b	—	—
5. d	—	—	35. a	—	—	65. d	—	—	95. a	—	—	125. a	—	—	155. c	—	—
6. a	—	—	36. c	—	—	66. a	—	—	96. c	—	—	126. a	—	—	156. c	—	—
7. a	—	—	37. c	—	—	67. b	—	—	97. c	—	—	127. d	—	—	157. c	—	—
8. d	—	—	38. d	—	—	68. d	—	—	98. a	—	—	128. c	—	—	158. c	—	—
9. d	—	—	39. b	—	—	69. a	—	—	99. d	—	—	129. c	—	—	159. b	—	—
10. d	—	—	40. a	—	—	70. d	—	—	100. c	—	—	130. d	—	—	160. d	—	—
11. d	—	—	41. d	—	—	71. c	—	—	101. c	—	—	131. b	—	—	161. a	—	—
12. c	—	—	42. c	—	—	72. a	—	—	102. b	—	—	132. c	—	—	162. d	—	—
13. a	—	—	43. b	—	—	73. a	—	—	103. a	—	—	133. b	—	—			
14. b	—	—	44. b	—	—	74. d	—	—	104. c	—	—	134. b	—	—			
15. c	—	—	45. c	—	—	75. c	—	—	105. b	—	—	135. a	—	—			
16. a	—	—	46. b	—	—	76. b	—	—	106. a	—	—	136. a	—	—			
17. d	—	—	47. d	—	—	77. a	—	—	107. d	—	—	137. b	—	—			
18. b	—	—	48. b	—	—	78. b	—	—	108. d	—	—	138. a	—	—			
19. c	—	—	49. b	—	—	79. a	—	—	109. b	—	—	139. b	—	—			
20. c	—	—	50. b	—	—	80. b	—	—	110. c	—	—	140. c	—	—			
21. c	—	—	51. c	—	—	81. d	—	—	111. a	—	—	141. c	—	—			
22. a	—	—	52. d	—	—	82. a	—	—	112. c	—	—	142. d	—	—			
23. b	—	—	53. b	—	—	83. c	—	—	113. b	—	—	143. d	—	—			
24. c	—	—	54. c	—	—	84. c	—	—	114. d	—	—	144. c	—	—			
25. b	—	—	55. b	—	—	85. c	—	—	115. a	—	—	145. d	—	—			
26. c	—	—	56. c	—	—	86. c	—	—	116. d	—	—	146. c	—	—			
27. b	—	—	57. b	—	—	87. a	—	—	117. c	—	—	147. d	—	—			
28. c	—	—	58. a	—	—	88. d	—	—	118. d	—	—	148. d	—	—			
29. c	—	—	59. a	—	—	89. b	—	—	119. c	—	—	149. c	—	—			
30. c	—	—	60. c	—	—	90. a	—	—	120. a	—	—	150. d	—	—			
															1st: __/162 = __%		
															2nd: __/162 = __%		

Explanations

1. (b) The requirement is to identify the reply that is **not** an assertion for classes of transactions. The assertions for classes of transactions are occurrence, completeness, accuracy, cutoff and classification. Answer (b) is correct since consistency is not an assertion for classes of transactions. Answer (a), (c), and (d) are all incorrect because accuracy, cutoff and occurrence are class of transaction assertions.

2. (c) The requirement is to identify the type of evidence that is generally most reliable. Answer (c) is correct because audit evidence obtained from knowledgeable independent sources outside the client company is more reliable than audit evidence obtained from nonindependent sources (e.g., company sources who may be biased). Answer (a) is incorrect because audit evidence obtained from direct sources is more reliable. Answer (b) is incorrect because it is not clear as to whether copies or facsimile copies are more reliable. Answer (d) is incorrect because it is unclear whether audit evidence provided by original documents is more reliable than that

provided through a system of effective controls—indeed, they may be one and the same.

3. (c) The requirement is to identify the most persuasive type of evidence. Answer (c) is correct because a bank statement represents evidence prepared outside of the entity and is considered an audit evidence source which provides the auditor with a high level of assurance. Answers (a), (b), and (d) are incorrect because prenumbered client purchase order forms, client work sheets and a representation letter all represent internally generated documents, generally considered less persuasive than externally generated documents.

4. (d) The requirement is to identify a correct presumption about the reliability of audit evidence. Answer (d) is correct because AU-C 500 indicates that effective internal control provides more assurance about the reliability of audit evidence than ineffective control. Answer (a) is incorrect because information obtained directly is considered more reliable than that obtained indirectly. Answer (b) is incorrect because audit evidence is normally persuasive rather than convincing.

Answer (c) is incorrect because reliability of audit evidence relates to the appropriateness of audit evidence.

5. (d) The requirement is to determine the correct statement with respect to the appropriateness of audit evidence. To be appropriate, evidence must be both reliable and relevant. Answer (a) is incorrect because while externally generated evidence is generally considered to provide greater assurance of reliability, there are important exceptions, (e.g., the confirmation is erroneously returned with no exception when one actually exists). Answer (b) is incorrect because while evidence so gathered is typically considered to provide greater assurance concerning reliability, no similar generalization can be made about its relevance. Answer (c) is incorrect because oral representations from management, when corroborated by other forms of evidence, are considered valid evidence.

6. (a) The requirement is to identify the **least** persuasive type of evidence. Answer (a) is correct because evidence secured solely from within the entity, here prenumbered purchase order forms, is considered less persuasive than evidence obtained from independent sources. Answer (b) is incorrect because a bank statement (even though received from the client) is externally created and therefore more persuasive than audit evidence secured solely from within the entity. Answer (c) is incorrect because evidence obtained directly by the auditor through observation is considered relatively persuasive. Answer (d) is incorrect because correspondence from the client's attorney about litigation is obtained directly from independent sources and is therefore more persuasive than audit evidence secured from within the entity.

7. (a) The requirement is to identify an area of concern to auditors when evaluating the reasonableness of an entity's accounting estimates. Answer (a) is correct because AU-C 500 states that in evaluating the reasonableness of estimates auditors normally concentrate on assumptions that are subjective and susceptible to bias. Answer (b) is incorrect because all things being equal, an auditor would expect assumptions that are consistent with prior periods. Answer (c) is incorrect because assumptions that are insensitive to variations in underlying data have little predictive ability. Answer (d) is incorrect because, often, one would expect assumptions similar to industry guidelines.

8. (d) The requirement is to identify the reply that is **not** a basic procedure used in an audit. Answer (d) is correct because the term "test of direct evidence" is not used in the professional standards. Answer (a) is incorrect because risk assessment procedures are used while obtaining an understanding of the client. Answer (b) is incorrect because substantive procedures test account balances. Answer (c) is incorrect because tests of controls test the operating effectiveness of controls.

9. (d) The requirement is to identify the procedure an auditor would perform first in evaluating management's accounting estimates for reasonableness. Answer (d) is correct because in evaluating reasonableness, the auditor should first obtain an understanding of how management developed the estimate. Answers (a), (b), and (c) are all incorrect because developing independent expectations, considering appropriate-

ness of key factors or assumptions, and testing calculations occur after obtaining the understanding. See AU-C 500 for information on auditing accounting estimates.

10. (d) The requirement is to identify a factor that an auditor would concentrate upon when evaluating the reasonableness of an accounting estimate. Answer (d) is correct because AU-C 500 states that the auditor normally concentrates on key factors and assumptions that are deviations from historical patterns, as well as those that are significant to the accounting estimate, sensitive to variations, and subjective and susceptible to misstatement and bias. Answer (a) is incorrect because deviations from historical patterns, not consistent patterns, are concentrated upon. Answer (b) is incorrect because factors and assumptions that are similar to industry guidelines are often reasonable. Answer (c) is incorrect because subjective factors and assumptions that are susceptible to bias are concentrated upon, not objective ones that are **not** susceptible to bias. See AU-C 500 for information on the manner in which auditors consider accounting estimates.

11. (d) The requirement is to identify one of an auditor's objectives when evaluating an entity's accounting estimates. Answer (d) is correct because when evaluating accounting estimates an auditor's objectives are to obtain sufficient appropriate audit evidence that (1) all material accounting estimates have been developed, (2) those accounting estimates are reasonable, and (3) those accounting estimates are in conformity with GAAP.

12. (c) The requirement is to determine the proper test for the existence assertion of an asset. Answer (c) is correct because testing **from** accounting records **to** the supporting evidence discloses whether recorded transactions occurred and whether the asset exists. Answer (a) is incorrect because testing for the completeness assertion addresses whether there are unrecorded items. Also, the aggregated nature of the financial statements makes the use of potentially unrecorded items unlikely as a method of identifying unrecorded items. Answer (b) is incorrect because testing potentially unrecorded items to the financial statements addresses the completeness assertion. Answer (d) is incorrect because testing from the supporting evidence to the accounting records addresses the completeness assertion. See the outline of AU-C 500 for information on the financial statement assertions.

13. (a) The requirement is to determine which balance remaining in a "suspense" account would be of most concern to an auditor. Answer (a) is correct because suspense debits that management believes will benefit future operations must be audited carefully to determine whether they have value and should be classified as an asset. Answer (b) is incorrect because when an auditor has already determined that a suspense debit has value it becomes a relatively straightforward issue of the item's proper classification. Answer (c) is incorrect because the conservative approach taken in audits is likely to cause the auditor to have somewhat more concern about suspense purported to be assets [i.e., answer (a)], than for those classified as current liabilities. Answer (d) is incorrect because when the auditor determines that the suspense credits represent customer deposits, establishing a proper accounting will ordinarily be relatively simple.

14. (b) The requirement is to identify the procedure that would **not** be considered an analytical procedure. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Answer (b) is correct because projecting an error rate from a statistical sample to an actual population is not a comparison of a plausible relationship. Answers (a), (c), and (d) are all incorrect because they all include a study of plausible relationships.

15. (c) The requirement is to identify the type of analytical procedure an auditor would **most** likely use in developing relationships among balance sheet accounts when reviewing the financial statements of a nonpublic entity. Answer (c) is correct because balance sheet accounts may be analyzed through a number of ratios (e.g., current ratio). Answer (a) is incorrect because trend analysis is often more appropriate for income statement analysis. Answer (b) is incorrect because regression analysis, while used in practice, is not used as frequently as is ratio analysis. Answer (d) is incorrect because risk analysis in and of itself is not a type of analytical procedure. See AR 100 for information on reviews of nonissuer (nonpublic) entities.

16. (a) The requirement is to identify how an auditor may achieve audit objectives related to particular assertions. Answer (a) is correct because an auditor may perform analytical procedures to achieve an audit objective related to a particular assertion. Answer (b) is incorrect because a system of quality control provides the CPA firm with reasonable assurance of conforming with professional standards. Answer (c) is incorrect because while working papers provide support for the audit report and aid in the conduct and supervision of the audit, they do not in and of themselves achieve audit objectives (see AU-C 230 for information on audit working papers). Answer (d) is incorrect because increasing the level of detection risk does not in and of itself achieve audit objectives.

17. (d) The requirement is to identify the procedure **most** likely to detect a fraud involving misstatement of income statements due to the recording of journal entries with unusual combinations of debits and credits to expense and revenue accounts. Answer (d) is correct because an objective of analytical procedures is identification of unusual transactions and events, and amounts, ratios and trends that might indicate misstatements. Answer (a) is incorrect because the limited number of journal entries traced to the general ledger in a sample is unlikely to include the erroneous journal entries. Answer (b) is incorrect because while an evaluation of the effectiveness of internal control might help detect such misstatements, it is somewhat doubtful due to the fact that it is likely that few journal entries are involved. Answer (c) is incorrect because there is no indication that the fraud involves differences between controlling accounts and subsidiary records.

18. (b) The requirement is to identify the account that would yield the highest level of evidence through the performance of analytical procedures. As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the auditor's expectation. Relationships involving income statement accounts tend to

be more predictable than relationships involving only balance sheet accounts, and relationships involving transactions not subject to management discretion are generally more predictable. Answer (b) is correct because interest expense relates to the income statement, and because interest expense is subject to only limited management discretion, given the existence of the related debt. Answers (a) and (c) are incorrect because accounts receivable and accounts payable are balance sheet accounts. Answer (d) is incorrect because travel and entertainment expense is normally subject to management discretion. See AU-C 520 for more information on the use of analytical procedures.

19. (c) The requirement is to determine what is included when analytical procedures are used in the overall review stage of an audit. Answer (c) is correct because the overall review stage includes reading the financial statements and notes and considering the adequacy of evidence gathered in response to unusual or unexpected balances. Answer (a) is incorrect because analytical procedures are not particularly aimed at gathering evidence on account balances that have not changed. Answer (b) is incorrect because analytical procedures do not directly test control procedures. Answer (d) is incorrect because tests of transactions to corroborate management's financial statement assertions are performed when considering internal control and for substantive procedures of transactions. See AU-C 520 for information on analytical procedures.

20. (c) The requirement is to determine the most predictable relationship for purposes of analytical procedures applied as substantive procedures. Answer (c) is correct because AU-C 520 indicates that relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts. Answer (a) is incorrect because, as indicated, relationships involving income statements are considered more predictable. Answer (b) is incorrect because relationships involving transactions subject to management discretion are often less predictable. For example, management might incur maintenance expense rather than replace plant and equipment, or they may delay advertising expenditures. Answer (d) is incorrect because prior year data is sometimes not a reliable predictor of subsequent year's data.

21. (c) The requirement is to identify a basic premise underlying the application of analytical procedures. Answer (c) is correct because, as indicated in AU-C 520, a basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. Answer (a) is incorrect because the study of financial ratios is an approach to identifying unusual fluctuations, not an acceptable alternative to investigating them. Answer (b) is incorrect because analytical procedures may be either statistical or nonstatistical. Answer (d) is incorrect because analytical procedures may be used as substantive procedures, and may result in modification of the scope of tests of balances and transactions.

22. (a) The requirement is to identify the stages of an audit for which the use of analytical procedures is required. AU-C 315 and AU-C 520 require the use of analytical procedures at

both the risk assessment and near completion of the audit, but not as a substantive procedure.

23. (b) The requirement is to determine the reply that would facilitate an auditor's analytical procedures. Answer (b) is correct because use of a standard cost system (a form of budgeting) produces variance reports that will allow the auditor to compare the financial information with the standard cost system data to identify unusual fluctuations. See AU-C 520 for the approach used. Answer (a) is incorrect because segregating obsolete inventory before the inventory count is related to the auditor's physical inventory observation and will not necessarily affect analytical procedures. Answer (c) is incorrect because correcting a material weakness in internal control before the beginning of the audit generally will have minimal, if any, effect on the historical information used for analytical procedures. Answer (d) is incorrect because data from independent sources outside the entity is more likely to be reliable than purely internal sources.

24. (c) The requirement is to identify the **most** likely effect on an audit of having performed analytical procedures near the end of an audit which suggest that several accounts have unexpected relationships. Answer (c) is correct because when unexpected relationships exist, additional tests of details are generally required to determine whether misstatements exist. Answer (a) is incorrect because irregularities (fraud) may or may not exist. Answer (b) is incorrect because internal control activities may or may not be operating effectively. Answer (d) is incorrect because ordinarily the situation need not be communicated to the audit committee.

25. (b) The requirement is to identify the comparison an auditor **most** likely would make in evaluating an entity's costs and expenses. Answer (b) is correct because payroll expense is an income statement expense and because it may be expected to have a relationship with that of the prior year. Answer (a) is incorrect because the accounts receivable account is not a cost or expense. Answer (c) is incorrect because comparing budgeted sales with actual sales of the current year is more likely to be performed than comparing budgeted sales with those of prior years. Answer (d) is incorrect because comparing the budgeted current year's warranty expense with the current year's contingent liabilities is less direct than that in answer (b), and because one would be more likely to compare current year budgeted warranty expense with actual warranty expense.

26. (c) The requirement is to identify the **best** individual to perform analytical procedures near the end of an audit. At this point the objective of analytical procedures is to assist the auditor in assessing the conclusions reached and in the evaluation of the overall financial statement presentation. Answer (c) is correct because an experienced individual with business and industry knowledge is likely to be able to fulfill this function. Answer (a) is incorrect because a staff accountant who has performed the substantive auditing procedures may not be able to objectively perform the analytical procedure and may not have the necessary

experience to perform the function. Answer (b) is incorrect because the managing partner of the office may not be close enough to the audit to perform the function effectively. Answer (d) is incorrect because the individual in charge of quality control and the peer review program should be as independent as possible of the audits he or she is considering. See AU-C 520 for guidance on analytical procedures.

27. (b) The requirement is to identify the **best** example of a substantive procedure. Answer (b) is correct because confirmation of balances of accounts receivable will provide a test of the ending account balance and is therefore a detailed test of a balance, a type of substantive procedure. Answers (a) and (c) are incorrect because examining approval of cash disbursements and comparison of signatures on checks to a list of authorized check signers are tests of controls. Answer (d) is incorrect because flowcharting a client's cash receipts system is a method used to document the auditor's understanding of internal control.

28. (c) The requirement is to identify the objective of tests of details of transactions performed as substantive procedures. Answer (c) is correct because AU-C 330 states that the objective of tests of details of transactions performed as substantive procedures is to detect material misstatements in the financial statements. Answer (a) is incorrect because while performing tests of details of transactions as substantive procedures complies with generally accepted auditing standards, this is not their objective. Answers (b) and (d) are incorrect because neither attaining assurance about the reliability of the accounting system nor the evaluation of the operating effectiveness of management's policies and procedures are the objective of tests of details of transactions performed as substantive procedures.

29. (c) The requirement is to find the statement which describes substantive audit tests. Answer (c) is correct because substantive procedures are defined as tests of transactions, direct tests of financial balances, or analytical procedures. Answer (a) is incorrect because substantive procedures may not be eliminated due to the limitations of internal control. Answer (b) is incorrect since substantive procedures primarily directly test ending financial statement balances, not subsequent events. Answer (d) is incorrect because substantive procedures **decrease** with increased reliance on internal control.

30. (c) The requirement is to determine the account for which the auditor is **most** likely to perform extensive tests for possible understatement. An analysis of past audits, in which existing financial statement errors were not discovered prior to the issuance of the financial statements, reveals that the great majority of the errors resulted in overstated profits. Therefore, the risk to a CPA is that the client is overstating profits. Answer (c) is correct because it is the only item whose understatement results in overstated profits. Answers (a), (b), and (d) are incorrect because understatement of these items would result in understated profits.

31. (c) The requirement is to determine the direction of audit testing to determine whether transactions have been recorded. Answer (c) is correct because to determine whether transactions have been recorded the auditor will test **from** the original source documents **to** the recorded entries. Answers (a), (b), and (d) are incorrect because when testing from the general ledger, the adjusted trial balance, or from general journal entries the auditor is dealing with the entries that have been recorded, not whether all transactions have been recorded.

32. (b) The requirement is to identify the correct statement concerning the deletion of audit documentation. Answer (b) is correct because after the audit file has been completed (ordinarily 60 days or less after the issuance of the audit report), no portions of audit documentation should be deleted. Answer (a) is incorrect because after completion of the audit file no documentation should be deleted or discarded. Answer (c) is incorrect because professional skepticism is not the basis for determining deletions. Answer (d) is incorrect because prior to the file completion date most superseded documentation may be deleted (an exception is that information that reflects a disparate point of view should be retained).

33. (a) The requirement is to determine how long audit documentation must be retained. Answer (a) is correct because AU-C 230 requires that they be maintained a minimum of five years. Answers (b), (c), and (d) all present other, incorrect time periods.

34. (a) The requirement is to identify the **most** likely pair of accounts to be analyzed on the same working paper. Answer (a) is correct because an auditor will often consider interest income with notes receivable because the interest is earned on those notes and therefore closely related. Answer (b) is incorrect because interest receivable relates to an asset account (notes receivable) while accrued interest payable relates to a liability account (notes payable) and accordingly one would expect separate working papers. Answer (c) is incorrect because notes payable and receivable are entirely separate accounts. Answer (d) is incorrect because interest income relates to interest-bearing securities while interest expense relates to debt accounts.

35. (a) The requirement is to identify a **primary** purpose of an auditor's working papers. AU-C 230 states that working papers serve mainly to provide the principal support for the auditor's report and to aid the auditor in the conduct and supervision of the audit.

36. (c) The requirement is to identify the **least** likely item to be included in the permanent file of an auditor's working papers. Answer (c) is correct because permanent files include information affecting a number of years' audits, and the working trial balance relates most directly to the current and, to a limited extent, the subsequent year's audit. Answers (a), (b), and (d) are all incorrect because bond indenture agreements, lease agreements, and a flowchart of internal control affect more years' audits than does a specific year's working trial balance.

37. (c) The requirement is to determine a difference between an auditor's working trial balance and financial statements without footnotes. Answer (c) is correct because a working trial balance includes columns for reclassification and adjustments. Answers (a), (b), and (d) are all incorrect because while they suggest information that might be included on a working trial balance, they will not be included in the form of additional columns.

38. (d) AU-C 230 states that the degree of documentation for a particular audit area should be affected by (1) the risk of material misstatement, (2) extent of judgment, (3) nature of the auditing procedures, (4) significance of the evidence obtained, (5) nature and extent of the exceptions identified, and (6) the need to document a conclusion that is not obvious from the documentation of the work.

39. (b) The requirement is to identify the required documentation in an audit. Answer (b) is correct because AU-C 300 requires documentation of the audit strategy and the audit plan (as well as significant changes made during the audit). Answer (a) is incorrect because while flowcharts and narratives are acceptable methods of documenting an auditor's understanding of internal control, they are not required. Answer (c) is incorrect because major stakeholder groups need not be documented. Answer (d) is incorrect because completion of an internal control questionnaire is not required.

40. (a) The requirement is to identify a factor that would **most** likely affect the auditor's judgment about the quantity, type, and content of the working papers. Answer (a) is correct because the Professional Standards state that the assessed level of control risk will affect the quantity, type and content of working papers. AU-C 230 provides a listing of this and other factors. For example, the quantity, type and content of working papers will be affected by whether tests of controls have been performed.

41. (d) The requirement is to identify the type of audit working paper that reflects the major components of an amount reported in the financial statements. Answer (d) is correct because lead schedules aggregate the major components to be reported in the financial statements. Answer (a) is incorrect because an interbank transfer schedule summarizes transfers between banks among accounts. Answer (b) is incorrect because the term "carryforward schedule" is not frequently used. Answer (c) is incorrect because supporting schedules present the details supporting the information on a lead schedule. For example, a detailed bank reconciliation for a cash account might serve as a supporting schedule for an account on the cash lead schedule.

42. (c) The requirement is to identify the documentation that is required for an audit in accordance with generally accepted auditing standards. Answer (c) is correct because the professional standards requires that the working papers show that the accounting records agree or reconcile with the financial statements. Answer (a) is incorrect because neither a flowchart nor an internal control questionnaire is required. Answer (b) is incorrect because the *Professional Standards* allow either an engagement letter or other suitable form of written agreement, and because this level of detail is not

included in and engagement letter. Answer (d) is incorrect because when control risk is assessed at the maximum level, the auditor's understanding of internal control needs to be documented, but the basis for the conclusion that it is at the maximum level need not be documented.

43. (b) The requirement is to identify the point at which no deletions of audit documentation are allowed. Answer (b) is correct because the professional standards indicate that audit documentation may not be deleted after the documentation completion date. Answer (a) is incorrect because documentation may be deleted between the client's year-end date and the documentation completion date. Answer (c) is incorrect because the last date of significant fieldwork is prior to the documentation completion date. Answer (d) is incorrect because the report release date is up to 60 days prior to the documentation completion date; 45 days for issuer (public) company audits.

44. (b) The requirement is to determine the type of auditor that should be able to understand audit documentation of the nature, timing, extent, and results of audit procedures performed. Answer (b) is correct because PCAOB Standard 3 requires that audit documentation be understandable to an experienced auditor having no prior connection with the engagement. Answer (a) is incorrect because the requirement is not limited to audit team members. Answer (c) is incorrect because the requirement is more limited than to any certified public accountant. Answer (d) is incorrect both because there is no certification of a peer review specialist and because this is not a requirement.

45. (c) The requirement is to identify the period for which audit documentation should be retained for issuer (public) company audits. Answer (c) is correct because PCAOB Standard 3 requires that audit documentation be retained for the longer of seven years or the period required by law. Answer (a) is incorrect both because of the seven-year requirement, and because it is the longer of seven years or the period required by law. Answer (b) is incorrect because while seven years is the general requirement, a longer period may be required by law. Answer (d) is incorrect because audit documentation need not be retained indefinitely.

46. (b) The requirement is to identify the information that an auditor usually confirms on one form. Answer (b) is correct because the standard form to confirm account balance information with financial institution requests information on both the cash in bank and collateral for loans. Answers (a), (c), and (d) are all incorrect because they suggest pairs of information that are not usually confirmed on one form.

47. (d) The requirement is to determine a reason that the usefulness of the standard bank confirmation request may be limited. Answer (d) is correct because the bank employee who completes the form often will not have access to all the financial relationships that the bank has with the client. Answer (a) is incorrect because bank employees who complete the form realize that they may verify confidential information with the auditor. Answer (b) is incorrect because while it is correct that the employee who completes the confirmation form will not generally inspect the accuracy

of the bank reconciliation, this does not limit the confirmation's usefulness. Answer (c) is incorrect because the employee who completes the form does not need to have access to the client's cutoff bank statement to complete the confirmation.

48. (b) The requirement is to determine the type of evidence that is likely to result in an auditor limiting substantive audit tests of sales transactions when control risk is assessed as low for the occurrence assertion for sales. Answer (b) is correct because an auditor may analyze the completeness of sales using cash receipts and accounts receivable (for example, an auditor may add year-end receivables to cash receipts and subtract beginning receivables to obtain an estimate of sales). Answer (a) is incorrect because the opening and closing inventory balances will only provide indirect evidence on sales through calculation of the cost of goods sold. Answer (c) is incorrect because while shipping as of year-end will help assure an accurate cutoff of sales, the receiving activity has no necessary relationship to the sales figure. Answer (d) is incorrect because while the cutoff of sales will provide evidence on the completeness of sales, the purchases portion of the reply is not appropriate.

49. (b) The requirement is to determine the two checks that might indicate kiting, a form of fraud that overstates cash by simultaneously including it in two or more bank accounts. Answer (b) is correct because checks #202 and #404 include cash in two accounts at year-end. The cash represented by check #202 is included in both State Bank and County Bank cash as of December 31. This is because its receipt is recorded prior to year-end, but its disbursement is recorded after year-end. (For the cash receipts journal to remain in balance prior to year-end, some account must have been credited on December 30 to offset the debit to cash.) Check #404 also represents a situation in which the cash is included in two accounts as of year-end; the check may represent a situation in which a shortage in the account is concealed through deposit of the check that is not recorded on the books at year-end. Check #101 does not result in a misstatement of cash since the books recorded both the debit and credit portions of the entry before year-end, while both banks recorded them after year-end. Check #303 represents a situation in which funds are disbursed on the Federal account as of year-end, but not received into the American account (per bank or per books) until after year-end; check #303 accordingly understates cash and the nature of the debit for the entry on December 31 is unknown. Answer (a) is incorrect because neither check #101 nor #303 overstates cash. Answer (c) is incorrect because check #101 does not overstate cash. Answer (d) is incorrect because check #303 understates cash.

50. (b) The requirement is to determine the checks which represent deposits in transit at December 31, 2001. Deposits in transit are those that have been sent to the bank prior to year-end, but have not been received by the bank as of year-end. Answer (b) is correct because both check #101 and check #303 have been disbursed per books as of year-end, but have not yet been received by the bank as of December 31. Checks #202 and #404 have been received by the bank as of year-end and accordingly are not in transit. Answer (a) is incorrect because

check #202 has been received before year-end. Answer (c) is incorrect because both checks #202 and #404 have been received before year-end. Answer (d) is incorrect because check #404 has been received before year-end.

51. (c) The requirement is to identify why auditors trace bank transfers for the last part of the audit period and the first part of the subsequent period. Answer (c) is correct because auditors use a bank transfer schedule to analyze transfers so as to detect kiting that overstates cash balances. Answers (a) and (b) are incorrect because the process of analyzing transfers is not an efficient way to determine whether the cash receipts journal was held open or when the year's final checks were mailed. Auditors use a bank cutoff statement rather than a bank transfer schedule to help detect these situations. Answer (d) is incorrect because the process of analyzing transfers is unlikely to identify any unusual payments or receipts from related parties.

52. (d) The requirement is to determine the source of evidence which does **not** contain information on the balance per bank in a bank reconciliation. Answer (d) is correct because the general ledger contains only the client's cash balance, not the balance per bank. Answer (a) is incorrect because the beginning balance on a cutoff statement represents the year-end bank balance. Answer (b) is incorrect because the primary purpose of a year-end bank statement is to present information on the balance per bank. Answer (c) is incorrect because the first question on a standard bank confirmation form requests information on the year-end balance per bank.

53. (b) The requirement is to identify the cash transfer which will result in a misstatement of year-end cash. Answer (b) is correct because the receipt is recorded on the books prior to year-end, while the disbursement is recorded subsequent to year-end. Therefore, the cash on the books is overstated. Answers (a), (c), and (d) are incorrect because they do not reveal a cutoff error. Answer (a) is incorrect because both the disbursement and receipt are recorded on the books prior to year-end; note that one would expect to see an outstanding check on the disbursing bank reconciliation as of year-end. Answer (c) is incorrect because both the disbursement and receipt are recorded on the books prior to year-end; one would expect the disbursing bank reconciliation to show an outstanding check and the receiving bank to show a deposit in transit as of year-end. Answer (d) is incorrect because the entire transaction is recorded after year-end.

54. (c) The requirement is to determine an approach for detecting the concealing of a cash shortage by transporting funds from one location to another or by converting negotiable assets to cash. Answer (c) is correct because the timing of the performance of auditing procedures involves the proper synchronizing of their application and thus comprehends the possible need for simultaneous examination of, for example, cash on hand and in banks, securities owned, bank loans, and other related items.

55. (b) The requirement is to identify the **primary** purpose of sending a standard confirmation request to financial institutions with which the client has done business during the year. Answer (b) is correct because CPAs generally provide the account information on the form and ask for

balance corroboration. The form explicitly states that the CPAs do not request, nor expect, the financial institution to conduct a comprehensive, detailed, search of its records for other accounts. Answer (a) is incorrect because a standard confirmation request will not detect kiting, a manipulation causing an amount of cash to be included simultaneously in the balance of two or more bank accounts. Answer (c) is incorrect because bank statements available from the client allow the CPA to prepare a proof of cash. Answer (d) is incorrect because the standard form does not request information about contingent liabilities and secured transactions.

56. (c) The requirement is to determine the assertion (or assertions) being tested by a test of a control in which an auditor observes the mailing of monthly statements to a client's customers and reviews evidence of follow-up on errors reported by the customers. Answer (c) is correct because observing the mailing of monthly statements and follow-up of errors will provide evidence to the auditor as to whether the receivables **exist** at a given date; the tests do not directly address the presentation and disclosure assertion since little evidence is obtained about whether financial statement components are properly classified, described, and disclosed. See AU-C 500 for a discussion of the various financial statement assertions. Answer (a) is incorrect because the presentation and disclosure assertion is not addressed. Answer (b) is incorrect because the presentation and disclosure assertion is not addressed and because the existence or occurrence assertion is addressed. Answer (d) is incorrect because the existence or occurrence assertion is addressed.

57. (b) The requirement is to determine the **most** likely audit step summarized by the tick mark placed under "date disbursed per bank." Answer (b) is correct because the checks were written in December but cleared in January and should therefore be listed as outstanding on the year-end outstanding check list of the applicable bank reconciliation. Answer (a) is incorrect because the tick marks are beside the date per bank, and not per books. Answer (c) is incorrect because the December cash disbursements journal, and not the January cash disbursements journal, will include these disbursements. Answer (d) is incorrect because the year-end bank confirmations do not include information on outstanding checks.

58. (a) The requirement is to determine the **most** likely audit step summarized by the tick mark placed under "date deposited per bank." Answer (a) is correct because deposits recorded on the books as of 12/31 should be included as deposits in transit on the applicable bank reconciliation. Answer (b) is incorrect because the tick mark is placed beside the "bank" column, and not the books column. Answer (c) is incorrect because the December cash receipts journal, and not the January cash receipts journal should include the deposit. Answer (d) is incorrect because the year-end bank confirmations will not include deposits in transit.

59. (a) The requirement is to identify the correct statement concerning the use of negative confirmation requests. Answer (a) is correct because AU-C 505 states that unreturned negative confirmation requests rarely provide significant evidence concerning financial statements assertions other

than certain aspects of the existence assertion. Answer (b) is incorrect because positive, not negative, confirmation requests are normally used when a low level of detection risk is to be achieved. Answer (c) is incorrect because alternative procedures are not generally performed on unreturned negative confirmation requests since it is assumed that the respondent did not reply because of agreement with the balance on the confirmation request. Answer (d) is incorrect because respondents may not reply when misstatements are in their favor.

60. (c) The requirement is to identify the **most** likely action taken by an auditor when no reply is received to positive confirmation requests. Answer (c) is correct because asking the client to contact customers to ask that confirmation requests be returned may increase response rates. Answer (a) is incorrect because the lack of a reply to a confirmation request does not necessarily indicate that the account needs to be written off. Answer (b) is incorrect because accounts receivable confirmations deal more directly with existence than with valuation or completeness and because alternative procedures may provide the auditor with the desired assurance with respect to the nonrespondents. Answer (d) is incorrect because the assessed level of inherent risk will not normally be modified due to confirmation results.

61. (b) The requirement is to determine the **best** sampling unit for confirmation of accounts receivable when many differences between the recorded account balances and the confirmation replies have occurred in the past. Answer (b) is correct because the misstatements may have occurred because respondents are not readily able to confirm account balances. AU-C 505 suggests that in such circumstances certain respondents' accounting systems may facilitate the confirmation of single transactions (individual invoices) rather than of entire account balances.

62. (c) The requirement is to identify the assertion most directly addressed by accounts receivable confirmations. AU-C 500 presents information on financial statement assertions. Answer (c) is correct because a confirmation addresses whether the entity replying to the confirmation believes that a debt exists. Answer (a) is incorrect because while confirmations provide limited information on valuation, they do not directly address whether the entity replying will pay the debt (or whether the account has been factored). Answer (b) is incorrect because limited classification information is received via confirmations. Answer (d) is incorrect because confirmations are generally sent to recorded receivables, and are of limited assistance in the determination of whether all accounts are recorded (completeness).

63. (a) The requirement is to determine when alternative procedures should be performed in order to substantiate the existence of accounts receivable. Answer (a) is correct because the auditor should employ alternative procedures for nonresponses to positive confirmations to satisfy himself/herself as to the existence of accounts receivable. Those procedures may include examination of evidence of subsequent cash receipts, cash remittance advices, sales and shipping documents, and other records. Answer (b) is incorrect because with negative

confirmations the debtor is asked to respond only if s/he disagrees with the information on the confirmation; thus, no reply is assumed to indicate agreement. Answers (c) and (d) are incorrect because while **additional** procedures may be required when collectibility is questionable, **alternative** procedures are those used in lieu of confirmation.

64. (d) The requirement is to identify the **most** likely alternate procedure when replies have not been received to either first or second accounts receivable confirmation requests. Answer (d) is correct because the inspection of shipping records will provide evidence that the merchandise was actually shipped to the debtor. Answer (a) is incorrect because, a review of the cash receipts journal **prior** to year-end is unlikely to provide evidence on account recorded as unpaid as of year-end. Also, the procedure would only detect one specific type of misstatement, that in which payments were recorded in the cash receipts journal, but not credited to the customers' accounts. Answer (b) is incorrect because the lack of a reply to the confirmation provides no particular evidence that the scope of procedures related to internal control should be modified. Answer (c) is incorrect because the lack of a reply need not necessarily lead to a presumption that the account is misstated. See AU-C 505 for procedures typically performed for year-end accounts receivable confirmation requests for which no reply is received.

65. (d) The requirement is to identify the circumstances in which use of the negative form of accounts receivable confirmation **most** likely would be justified. Negative confirmations are used when (1) the combined assessed level of inherent and control risk is low, (2) a large number of small balances is involved, and (3) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration. Positive confirmations are used when those conditions are not met as well as in other circumstances in which it seems desirable to request a positive response, such as when accounts are in dispute. Answer (d) is best because small balances are involved and few accounts are in dispute. Answer (a) is incorrect because it refers to a substantial number of accounts in dispute and sales are to a few major customers. Answer (b) is incorrect because it refers to a substantial number of accounts in dispute. Answer (c) is incorrect because it refers to sales to a few major customers.

66. (a) The requirement is to identify a method to reduce the risk associated with accepting e-mail responses to accounts receivable confirmation requests. Answer (a) is correct because a response by mail will confirm the e-mail response. Answer (b) is incorrect because while such subsequent cash receipts will ordinarily be examined, this represents an alternative, complementary approach to confirmation. Answer (c) is incorrect because the auditor need not consider e-mail responses to be confirmations with exception. Answer (d) is incorrect because a second request is more likely to elicit either no response or another e-mail response.

67. (b) The requirement is to determine the **most** likely procedure to reduce the risks associated with accepting fax responses to requests for confirmations of accounts receivable. Answer (b) is correct because verification of the sources

and contents through telephone calls will address whether the information on the fax (which may have been sent from almost anywhere) is correct. Answer (a) is incorrect because an examination of the shipping documents is less complete than is verification of the entire balance. Answer (c) is incorrect because such faxes need not be treated as nonresponses. Answer (d) is incorrect because inspection of the faxes is unlikely to reveal forgeries or alterations, even when such circumstances have occurred.

68. (d) The requirement is to identify the circumstance in which the negative form of confirmation request **most** likely would be used. Answer (d) is correct because AU-C 505 states that negative confirmations may be used when (1) the combined assessed level of inherent and control risk is low [answer (d)], (2) a large number of small balances is involved, and (3) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration. Answer (a) is incorrect because when the accounts receivable are immaterial, a decision may be made to send no confirmations. Answer (b) is incorrect because an inadequate rate is not an acceptable reason to send negative confirmations. Answer (c) is incorrect because negative confirmations are only of value when the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

69. (a) The requirement is to identify the circumstance in which an auditor would use the blank form of confirmations (one which includes no amount and asks the respondent to supply the amount due) rather than positive confirmations. Answer (a) is correct because if a recipient simply signs a blank confirmation and returns it the confirmation will have no amount on it and the auditor will know that additional procedures are necessary. Answers (b) and (c) are incorrect because there is no necessary relationship between the use of blank confirmations and subsequent cash receipt verification difficulty and analytical procedures results. Answer (d) is incorrect because when the combined assessed level of inherent risk and control risk is low it is unlikely to lead to the blank form of confirmation. In fact, when that risk is low, and when adequate other substantive procedures of details, no confirmation may be necessary. See AU-C 505 for information on the confirmation process.

70. (d) The requirement is to identify the **most** likely information that would be included in a client's confirmation letter that is being used to confirm accounts receivable balances rather than individual invoices. Answer (d) is correct since including details of the account is likely to make it easier for the customer to respond in a meaningful manner. Answer (a) is incorrect because no such auditor-prepared letter will be included and because only in the case of the negative form of confirmation does a nonresponse lead to an inference that the account balance is correct. Answer (b) is incorrect because confirmation requests do not ordinarily include a letter suggesting that a second request will be sent. Answer (c) is incorrect because the auditor does not enclose a letter requesting that the information be supplied. See AU-C 505 for information on the confirmation process.

71. (c) The requirement is to identify a statement that an auditor would be **most** likely to add to the negative form of confirmation of accounts receivable to encourage a timely consideration by the recipient. Answer (c) is correct because providing such information might increase timely consideration in that the recipient may realize the importance of a reply when the information is incorrect. Answers (a) and (b) are incorrect because while a confirmation request may include these statements, the statements are unlikely to encourage timely consideration of the request. Answer (d) is incorrect because many accounts that are not overdue are sampled, and because even for those overdue such a statement is not ordinarily included with the confirmation request.

72. (a) The requirement is to identify the strategy **most** likely to improve the response rate for confirmation of accounts receivable. Answer (a) is correct because including a list of items or invoices that constitute the account balance makes it easier for the potential respondent to reply. Answer (b) is incorrect because customers with relatively large balances may or may not be more likely to reply. Answers (c) and (d) are incorrect because there is no research available indicating that requesting a fax or e-mail reply, or threatening a second request is likely to improve response rate.

73. (a) The requirement is to determine the financial statement most directly related to the procedure of making inquiries concerning possible obsolete or slow-moving inventory. Answer (a) is correct because inquiries concerning possible obsolete or slow-moving inventory deal with whether the inventory is being carried at the proper value and this is most directly related to the valuation assertion. The other assertions are less directly related. Answer (b) is incorrect because the rights assertion deals with whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. Answer (c) is incorrect because the existence assertion deals with whether assets exist at a given date. Answer (d) is incorrect because the presentation assertion deals with whether particular components of the financial statements are properly classified. See AU-C 500 for information on the financial statement assertions.

74. (d) The requirement is to identify the type of omitted journal entry that would result in inventory test counts that are higher than the recorded quantities in the client's perpetual records. Answer (d) is correct because a failure to record sales returns results in a situation in which the item is returned by a customer and included in the inventory count, but not recorded in the perpetual records; accordingly the test counts are higher than the recorded quantities. Answer (a) is incorrect because purchase discounts do not affect quantities in inventory. Answers (b) and (c) are incorrect because a failure to record purchase returns or sales result in a situation in which less inventory will be counted (since the items are no longer physically in inventory) than is recorded on the perpetual records.

75. (c) The requirement is to identify a procedure that will provide assurance that all inventory items in a client's inventory listing schedule are valid. Answer (c) is correct because tracing **from** the inventory listing schedule **to** inventory tags and **to** the auditor's recorded count sheets will

provide assurance that the listed items actually exist.

Answer (a) is incorrect because tracing from inventory tags to items in the inventory listing schedule tests the completeness of the inventory listing sheet, not whether all of the items it lists are valid. Answer (b) is incorrect because it does not directly test the client's inventory listing schedule. Answer (d) is incorrect because tracing items listed in receiving reports and vendors' invoices to the inventory listing schedule will provide assurance on the completeness of the inventory listing sheet; it will also be a difficult procedure to accomplish due to the fact that a number of these items will not be in inventory due to sales. See AU-C 500 for information on the testing of the various financial statement assertions.

76. (b) The requirement is to identify the factor that average inventory is divided into to calculate inventory turnover. Answer (b) is correct because the average inventory is divided into the cost of goods sold to calculate the inventory turnover.

77. (a) The requirement is to identify the auditing procedure that **most** likely would provide assurance about a manufacturing entity's inventory valuation. Answer (a) is correct because testing the overhead computation will provide evidence on whether inventory has been included in the financial statements at the appropriate amount. Answer (b) is incorrect because obtaining confirmation of inventories pledged under loan agreements relates more directly to the presentation assertion. Answers (c) and (d) are incorrect because reviewing shipping and receiving cutoff procedures for inventories and tracing test counts to the inventory listing relate more directly to the existence and completeness assertions.

78. (b) The requirement is to identify an action that an auditor might take when the assessed level of control risk is high for inventory. Answer (b) is correct because a high level of control risk will generally result in a low acceptable level of detection risk, which may be achieved by changing the timing of substantive procedures to year-end, changing the nature of substantive procedures to more effective procedures, and/or by changing the extent of substantive procedures. Answer (a) is incorrect because control risk has been assessed and tests of controls, if any, will already have been completed. Answer (c) is incorrect because a year-end count of inventory is more appropriate when control risk is high. Answer (d) is incorrect because gross profit tests will generally provide less assurance than is required in circumstances such as this when control risk is assessed at a high level.

79. (a) The requirement is to identify the financial statement assertion (other than presentation and disclosure) most directly related to an auditor's conclusion that no excessive costs for idle plant were charged to inventory. Answer (a) is correct because the assertion deals with whether the inventory has been included in the financial statements at the appropriate amount, and therefore that no excessive costs were charged to inventory. Answer (b) is incorrect because the completeness assertion deals with whether all inventory items that should be presented are so included. Answer (c) is incorrect because existence deals with whether the inventory actually exists at the given date. Answer (d) is incorrect because rights deal with whether the inventory is owned by the client. For more

information on management's financial statement assertions, see AU-C 500.

80. (b) The requirement is to identify the financial statement assertion most directly related to an auditor's tracing of inventory test counts to the client's inventory listing.

Answer (b) is correct because the completeness assertion deals with whether all transactions are included. Tracing from the inventory items observed to the inventory listing will help determine whether all the transactions are included and the inventory listing is complete. Answer (a) is incorrect because the rights assertion deals with whether assets are the rights of the entity and this is not being tested when an auditor traces test counts to an inventory listing. Answer (c) is incorrect because existence deals with whether the inventory existed at the date of the count. To test existence the auditor would sample from the inventory listing and compare quantities to the test counts. Answer (d) is incorrect because valuation deals with whether the inventory is properly included in the balance sheet at the appropriate dollar amount and this is not being tested here. See AU-C 500 for more information on management's financial statement assertions.

81. (d) The requirement is to determine the assertion most directly related to an auditor's analysis of inventory turnover rates. Answer (d) is correct because an analysis of inventory turnover rates will provide the auditor with evidence on slow-moving, excess, defective, and obsolete items included in inventories. These items may be improperly valued.

82. (a) The requirement is to determine which types of entries will be supported when the auditor examines receiving reports. Answer (a) is correct because receiving reports will be prepared when goods are received through purchase (as recorded in the voucher register) and when goods are received through sales returns (as recorded in the sales returns journal). Answers (b), (c), and (d) are incorrect because entries in sales journals result in items being shipped, not received. Note, however, that answers (b), (c), and (d) are partially correct because the sales returns journal, voucher register, and check register all result from transactions related to the receipt of goods.

83. (c) The requirement is to identify the response which does **not** represent one of the independent auditor's objectives regarding the examination of inventory. Answer (c) is correct because verifying that all inventory owned by the client is on hand at the time of the count is not an objective. For example, purchased items in transit at year-end, for which title has passed, should be included in inventory. Similarly, inventory out on consignment should also be included in inventory. Answer (a) is incorrect because proper presentation of inventory pertains to the presentation and disclosure assertion and therefore would be subject to auditor verification. Answers (b) and (d) are incorrect because proper accounting for damaged and obsolete items and proper inventory pricing pertain to the valuation assertion and therefore would be subject to auditor verification. See AU-C 500 for details on financial statement assertions.

84. (c) The requirement is to determine why an auditor should insist that a client representative be present when he

or she physically examines securities. Answer (c) is correct because requiring that a client representative acknowledge the receipt of the securities will eliminate any question concerning the CPA's responsibility for any subsequent misplacement or misappropriation of the securities. Answer (a) is incorrect because the client's representative will not in general help the CPA to detect fraudulent securities. Answers (b) and (d) are incorrect because while the client's representative will help the CPA to gain access to the securities and may coordinate their return, these are not the auditor's primary purpose.

85. (c) The requirement is to identify the **best** procedure other than inspection to establish the existence and ownership of a long-term investment in a publicly traded stock. Answer (c) is correct because confirmation of the number of shares owned that are held by an independent custodian is effective at testing existence. Answer (a) is incorrect because auditors do not in general correspond with the investee company and because that company may or may not have detailed information on the identity of shareholders at any point in time. Answer (b) is incorrect because while inspection of the audited financial statements of the investee company may provide limited information on valuation of the investment, it does not directly address existence; note that this procedure is of limited use here since the stock is publicly traded and obtaining its value through stock price quotations should not be difficult. Answer (d) is incorrect because this procedure addresses the valuation of the securities. In addition, under SFAS 115, investments are no longer carried at the lower of cost or market. See AU-C 500 for more information on management's financial statement assertions.

86. (c) The requirement is to determine the **best** procedure when an auditor has been unable to inspect and count a client's investment securities (held in a safe-deposit box) until after the balance sheet date. Answer (c) is correct because banks maintain records on access to safe-deposit boxes. Thus, the confirmation of no access during the period will provide the auditor with evidence that the securities in the safe-deposit box at the time of the count were those available at year-end. Answers (a) and (b) are incorrect because the bank will not generally be able to provide a list of securities added and removed from the box (typically, only records on access are maintained by the bank). Therefore, the bank will have no information on reconciling items between the subsidiary ledger and the securities on hand. Answer (d) is incorrect because it is the responsibility of the auditor and the client, not the bank, to count the securities maintained in a safe-deposit box.

87. (a) The requirement is to determine the **most** likely use of analytical procedures when testing long-term investments. Answer (a) is correct because the predictable relationship between long-term investments and investment income creates a situation in which analytical procedures may provide substantial audit assurance. Answer (b) is incorrect because the classification between current and noncurrent portfolios may be expected to fluctuate in an unpredictable manner as investment goals and the environment change. Answers (c) and (d) are incorrect because the valuation of marketable equity securities at the lower of cost or market and unrealized

gains or losses do not result in a predictable relationship on which analytical procedures may provide effective results.

88. (d) The requirement is to identify the account whose analysis is **least** likely to reveal evidence relating to **recorded** retirements of equipment. Answer (d) is correct because the purchase returns and allowances account deals with returns and allowances for purchases of merchandise, not equipment. Answer (a) is incorrect because analysis of accumulated depreciation will reveal the retirement through charges made to the accumulated depreciation account. Answer (b) is incorrect because companies will ordinarily modify insurance coverage when assets are retired. Answer (c) is incorrect because the property, plant, and equipment account will reflect the retirement.

89. (b) The requirement is to identify a likely explanation for a situation in which significant debits have been posted to the accumulated depreciation expense. Answer (b) is correct because debits to accumulated depreciation are properly recorded upon retirement of a plant asset. Answer (a) is incorrect because changing the useful lives of plant assets does not affect accumulated depreciation. Answer (c) is incorrect because understatement of the prior year's depreciation expense does not result in an adjustment to accumulated depreciation. Answer (d) is incorrect because overhead allocations do not ordinarily affect accumulated depreciation.

90. (a) The requirement is to identify the **best** procedure for testing unrecorded retirements of equipment. Answer (a) is correct because selecting items from the accounting records and attempting to locate them will reveal unrecorded retirements when the item cannot be located. Answer (b) is incorrect because depreciation entries will continue when retirements have not been recorded. Answer (c) is incorrect because the direction of the test is incorrect since beginning with the item is unlikely to reveal a situation in which an unrecorded retirement has occurred. Answer (d) is incorrect because scanning the general journal for **recorded** entries is unlikely to reveal **unrecorded** retirements of equipment.

91. (d) The requirement is to determine why an auditor analyzes repairs and maintenance accounts. Answer (d) is correct because clients often erroneously charge expenditures for property and equipment acquisitions as expenses rather than capitalize them as assets. An analysis of repairs and maintenance accounts will reveal such errors. Answer (a) is incorrect because while auditors will want to determine that noncapitalizable expenses for repairs and maintenance have been recorded in the proper period, analyzing only the recorded entries is an incomplete test since entries occurring after year-end will also need to be examined. Answer (b) is incorrect because procedures relating to the property and equipment account will be performed to determine whether such entries have been recorded in the proper period. Answer (c) is incorrect because analyzing the repairs and maintenance accounts only considers recorded entries and not whether all noncapitalizable expenditures for repairs and maintenance have been properly charged to expense.

92. (c) The requirement is to determine the information an auditor is **most** likely to seek from the plant manager.

The plant manager comes into day-to-day contact with the machinery when producing a product; that contact is likely to provide information on its condition and usefulness. Answers (a) and (d) are incorrect because the plant manager will generally not have detailed knowledge as to the adequacy of the provision for uncollectible accounts or the amount of insurance which is desirable. Answer (b) is incorrect because the plant manager will have limited knowledge concerning physical inventory observation procedures and their appropriateness.

93. (a) The requirement is to identify the document **least** likely to provide evidence regarding mortgage acquisition costs. Deeds generally consist of a legal conveyance of rights to use real property. Frequently the sales price is not even specified and the related mortgage acquisition costs are much less likely to be stated in a deed. Answer (b) is incorrect because cancelled checks would provide verification of mortgage acquisition costs. Answer (c) is incorrect because the closing statement would provide a detailed listing of the costs of acquiring the real property, including possible mortgage acquisition costs. Answer (d) is incorrect because examination of interest expense would also relate to the mortgage acquisition costs.

94. (b) The requirement is to determine the assertion(s) involved when an auditor is inspecting new additions on a list of property, plant, and equipment. Answer (b) is correct because an auditor who inspects new additions relating to property and equipment balances addresses existence or occurrence, but not presentation and disclosure; presentation and disclosure relates more directly to proper classification and note disclosures rather than account balances.

95. (a) The requirement is to determine the financial statement assertion most directly related to the procedure of reviewing or recomputing amortization of intangible assets. Answer (a) is correct because the amortization of intangible assets deals with whether the accounts are properly valued, the valuation assertion. The other assertions are less directly related. Answer (b) is incorrect because the existence or occurrence assertion deals with whether assets or liabilities exist at a given date and whether recorded transactions have occurred during a given period. Answer (c) is incorrect because the completeness assertion deals with whether all transactions and accounts that should be presented in the financial statements are so included. Answer (d) is incorrect because the rights and obligations assertion deals with whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. See AU-C 500 for information on the financial statement assertions.

96. (c) The requirement is to determine the **most** likely reason for the absence of the original insurance policy on plant equipment. Answer (c) is correct because the holder of the lien may also in certain circumstances maintain the original insurance policy. Answer (a) is incorrect because an insurance premium which is due but not recorded is unlikely to account for the lack of the original insurance policy. Answer (b) is incorrect because while coinsurance provisions are outlined in the policy, they are unlikely to be a reason that the policy is not available for inspection. Answer (d) is incorrect because

there is no obvious relationship between the understatement of insurance expense and the presence or absence of an insurance policy.

97. (c) The requirement is to identify the **best** audit procedures for identifying unrecorded liabilities. Answer (c) is correct because unrecorded liabilities eventually become due and must be paid. Accordingly, a review of cash disbursements after the balance sheet date is an effective procedure for detecting unrecorded payables. Answer (a) is incorrect because tracing a sample of accounts payable that have been recorded is not likely to result in identification of unrecorded liabilities. Answer (b) is incorrect because purchase orders issued after year-end will not result in liabilities as of year-end. Answer (d) is incorrect because disbursement entries recorded before year-end generally relate to accounts payable that have been paid before year-end.

98. (a) The requirement is to identify the appropriate population when using accounts payable confirmations directed towards obtaining evidence on the completeness assertion. Answer (a) is correct because to address completeness the auditor attempts to determine that all accounts payable are reflected, and a company potentially may be liable to any of its vendors. Answer (b) is incorrect because confirming based on recorded amounts addresses existence more directly than completeness. Answer (c) is incorrect because basing the sample on payees after year-end only deals with those payables that have been paid as of that point. Answer (d) is incorrect because open invoices are a less complete population than are vendors. See AU-C 505 for information on the confirmation process, and AU-C 500 for information on management's financial statement assertions.

99. (d) The requirement is to determine why confirmation of accounts payable is unnecessary. Accounts payable are usually not confirmed because there is better evidence available to the auditor, (i.e., examination of cash payments subsequent to the balance sheet date). If the auditor reviews all cash payments for a sufficient time after the balance sheet date for items pertaining to the period under audit and finds no such payments which were not recorded as liabilities at year-end, the auditor is reasonably assured that accounts payable were not understated. Answer (a) is a nonsense answer. Answer (b) is incorrect because AP balances could be paid during year-end audit work after the balance sheet date. Answer (c) is incorrect because whether or not legal action has been taken against the client is irrelevant to the confirmation procedure.

100. (c) The requirement is to identify the substantive procedure to be performed to verify the existence and valuation of recorded accounts payable. Answer (c) is correct because the vouching of various payable accounts to purchase orders and receiving reports will provide evidence that the debt was incurred and the related goods received, thereby providing evidence on the existence of the debt and its amount, or valuation. Answer (a) is incorrect because determining whether prenumbered purchase orders are used and accounted for relates more directly to the completeness with which purchases and accounts payable were recorded. Answers (b) and (d) are incorrect because the question addresses the existence

and valuation of **recorded** accounts payable, not unrecorded payables or payables with a zero balance.

101. (c) The requirement is to determine management's accounts payable assertion that an auditor will primarily focus on. Experience has indicated that overstated income is more of a risk than is understated income. Answer (c) is correct because the completeness assertion focuses upon whether payables have been omitted, thereby overstating income. Answer (a) is incorrect because the existence assertion deals with whether recorded accounts payable are overstated, thereby understating income. Answer (b) is incorrect because payables often require no particularly troublesome presentations and disclosures. Answer (d) is incorrect because payables are most frequently simply valued at the cost of the related acquisition. See AU-C 500 for more information on management's financial statement assertions.

102. (b) The requirement is to identify a likely reason for a recorded interest expense that seems excessive in relation to the balance in the bonds payable account. Answer (b) is correct because understated bonds payable will result in a lower account balance than is proper and thereby create a situation in which the interest expense appears excessive. Answers (a) and (d) are incorrect because an understated discount or an overstated premium on bonds payable result in situations in which the recorded interest expense seems lower than expected since the net bonds payable are overstated. Answer (c) is incorrect because understatements, not overstatements, of bonds payable will result in what appears to be an excessive rate of interest expense.

103. (a) The requirement is to determine the financial statement assertion most directly related to an auditor's inspection of loan agreements under which an entity's inventories are pledged. Answer (a) is correct because the presentation and disclosure assertion deals with whether particular components of the financial statements—such as loan agreement covenants—are properly classified, described, and disclosed. The other assertions are less directly related. Answer (b) is incorrect because the valuation or allocation assertion deals with whether asset, liabilities, revenue, and expense components have been included in the financial statements at the appropriate amounts. Answer (c) is incorrect because the existence or occurrence assertion deals with whether assets or liabilities exist at a given date and whether recorded transactions have occurred during a given period. Answer (d) is incorrect because the completeness assertion deals with whether all transactions and accounts that should be presented in the financial statements are so included. See AU-C 500 for information on the financial statement assertions.

104. (c) The requirement is to identify a procedure an auditor would perform in auditing long-term bonds payable. Answer (c) is correct because comparing interest expense with the bond payable amount will provide evidence as to reasonableness. Such a procedure may reveal either interest not expensed or debt not properly recorded. Answer (a) is incorrect because analytical procedures will not in general be performed on bond premiums and discounts since these accounts may easily be verified by examining details of the entry recording the debt issuance and any subsequent amor-

tization. Answer (b) is incorrect because an examination of the documentation of assets purchased with bond proceeds is only necessary when such a use of the funds is a requirement of the debt issuance. Answer (d) is incorrect because confirmation of bonds outstanding will often be with the trustee rather than with individual bondholders.

105. (b) The requirement is to determine how an auditor can **best** verify a client's bond sinking fund transactions and year-end balance. Answer (b) is correct because confirmation with the bond trustee represents externally generated evidence received directly by the auditor. Such evidence is considered very reliable. Answer (a) is incorrect because individual holders of retired bonds will have no information on actual bond sinking fund transactions or year-end balances. Answer (c) is incorrect because, while recomputing interest expense, interest payable, and amortization of bond discount or premiums are desirable procedures, they do not directly address bond sinking fund transactions and year-end balances. Answer (d) is similar to answer (c) in that it is desirable but does not address the actual bond sinking fund transactions and year-end balance.

106. (a) The requirement is to determine how an auditor ordinarily obtains evidence of stockholders' equity transactions. Answer (a) is correct because the board of directors will, in general, authorize changes in stockholders' equity. Answer (b) is less complete in that for small clients there may be no transfer agent, and because the transfer agent deals most directly with transfers of outstanding stock. Answer (c) is incorrect because canceled stock certificates are ordinarily available only for small clients. Answer (d) is incorrect because companies do not ordinarily have a "treasury stock certificate book."

107. (d) The requirement is to identify the procedure that is **most** likely when an auditor is performing tests concerning the granting of stock options. Answer (d) is correct because authorizing the issuance of stock options is ordinarily a decision made by the board of directors. Answer (a) is incorrect because the Secretary of State of the state of incorporation will not have this information on stock options. Answer (b) is incorrect because the existence of the option holders is not ordinarily a significant question. Answer (c) is incorrect because stock to be issued relating to options may be either from treasury stock or new issuances; accordingly, sufficient treasury stock need not be available.

108. (d) The requirement is to identify the assertion to which determining whether there are restrictions on retained earnings relates most directly. Answer (d) is correct because such restrictions will result in disclosures and thus the presentation and disclosure assertion is most directly being verified. Answer (a) is incorrect because the existence or occurrence assertion addresses whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period. Answer (b) is incorrect because the completeness assertion addresses whether all transactions and accounts that should be presented in the financial statements are so included. Answer (c) is incorrect because the valuation or allocation assertion addresses whether asset, liability, revenue, and expense

components have been included in the financial statements at appropriate amounts. See AU-C 500 for a discussion of financial statement assertions.

109. (b) The requirement is to identify the information an auditor should confirm with a client's transfer agent and registrar. Answer (b) is correct because when a client employs a transfer agent and registrar, there will be no stock certificate book to examine, and accordingly, information on shares issued and outstanding should be confirmed. Answers (a), (c), and (d) are incorrect because the transfer agent and registrar often will not have information on dividend restrictions, guarantees of preferred stock liquidation values, and the number of shares subject to agreements to repurchase.

110. (c) The requirement is to determine a likely step in the audit plan for retained earnings. The legality of a dividend depends in part on whether it has been properly authorized (state laws differ on specific requirements). Thus, the auditor must determine that proper authorization exists, as both cash and stock dividends affect retained earnings. Answer (a) is incorrect since only a memo entry is required for a stock split. Answer (b) is incorrect because the write-down of an account receivable will not, in general, be recorded in retained earnings. Answer (d) is incorrect because gains from the disposition of treasury shares are recorded in paid-in capital accounts.

111. (a) The requirement is to determine a source an auditor uses to test the reasonableness of dividend income from investments in publicly held companies. Answer (a) is correct because dividend record books produced by investment advisory services provide summaries of dividends paid for various securities, and an auditor is able to compare the reasonableness of a client's recorded dividend income from investments with this information. Answers (b) and (c) are incorrect because auditors do not, in general, determine the reasonableness of dividend income by examining stock "indentures" or "stock ledgers." Answer (d) is incorrect because while annual financial statements of investee companies may include such information, examining such financial statements is not generally an efficient approach for testing the reasonableness of dividend income. Also, the current year financial statements of the investees often are not available when the auditor is performing the current audit.

112. (c) The requirement is to identify the **most** likely risk involved with a bill and hold transaction at year-end. Answer (c) is correct because a bill and hold transaction results in the recording of a sale prior to delivery of the goods—accordingly, sales may be inappropriately recorded. Answer (a) is incorrect because accrued liabilities are not ordinarily affected by bill and hold transactions. Answers (b) and (d) are incorrect because an absolute purchase commitment and the assuming of risk and reward relating to the product represent conditions which increase the likelihood that recording of a sale for such a transaction is appropriate.

113. (b) The requirement is to identify the **most** likely listed effect of "channel stuffing." Answer (b) is correct because channel stuffing is a marketing practice that suppli-

ers sometimes use to boost sales by inducing distributors to buy substantially more inventory than they can promptly resell; accordingly, increased sales returns in the future are likely. Answers (a), (c) and (d) are incorrect because accrued liabilities, cash, and marketable investments are less likely to be affected by channel stuffing, which results in entries increasing accounts receivable, cost of goods sold, and sales, while decreasing inventory.

114. (d) The requirement is to identify the **most** likely audit procedure, in addition to analytical procedures, when control risk for payroll is assessed as low. Answer (d) is correct because accrual of payroll at year-end is not an entry made frequently throughout the year and accordingly recording of the entry is often not controlled by the payroll portion of the internal control structure. Answers (a), (b), and (c) are incorrect because observing the distribution of paychecks, the footing and crossfooting of the payroll register, and inspection of payroll tax returns are recurring operations that will have been considered when assessing control risk at a low level.

115. (a) The requirement is to identify the circumstance that **most** likely would cause an auditor to suspect an employee payroll fraud scheme. Answer (a) is correct because significant unexplained variances between standard and actual labor cost may lead an auditor to suspect fraud. Answer (b) is incorrect because one would expect payroll checks to be distributed by the same employees each payday. Answer (c) is incorrect because time cards are ordinarily approved by individual departmental supervisors. Answer (d) is incorrect because the maintenance of a separate payroll bank account is considered a control, not an indication of fraud.

116. (d) The requirement is to identify the procedure that an auditor **most** likely would perform when auditing payroll. Answer (d) is correct because a comparison of payroll costs with entity standards or budgets will generally be included in the audit plan as a test of overall payroll reasonableness. Answer (a) is incorrect because unclaimed wages will not be mailed unless an employee so requests and this often will not be tested by an auditor. Answer (b) is incorrect because total employee deductions will be traced to journal entries. Answer (c) is incorrect because observing entity employees during a payroll distribution is generally only included in an audit plan when internal control is weak; accordingly, it is more likely that a comparison of payroll costs with entity standards or budgets [answer (d)] will be included.

117. (c) The requirement is to determine when an auditor would be **most** likely to perform substantive procedures of details on payroll transactions and balances. Answer (c) is correct because analytical procedures result in further investigation when unexpected differences occur. This investigation will generally involve substantive procedures of details of transactions and balances. AU-C 520 provides detailed information on analytical procedures. Answer (a) is incorrect because a substantial amount of accrued payroll expense as indicated by a cutoff test will not necessarily result in additional substantive procedures. Answer (b) is incorrect because a low assessed level of control risk is likely to result in less substantive procedures. Answer (d) is incorrect because the nature of accrued payroll expense being unpaid

commissions need not necessarily result in more substantive procedures.

118. (d) The requirement is to identify the account in which a recorded entry is **most** likely to relate to the property, plant, and equipment completeness assertion. The completeness assertion addresses whether all transactions have been recorded in an account (here, property, plant, and equipment). Answer (d) is correct because the purchase of property, plant, and equipment may inappropriately have been recorded in the repairs and maintenance account rather than in property, plant, and equipment; this is a frequent bookkeeping error since the individual recording the entry may frequently see similar invoices which do represent repairs and maintenance expense. Answers (a), (b), and (c) are all incorrect because the allowance for doubtful accounts, marketable securities, and sales has no apparent relationship to the completeness of recording of property, plant, and equipment.

119. (c) The requirement is to identify the matter on which an auditor should obtain written management representations. Answer (c) is correct because written representations are ordinarily obtained on noncompliance with aspects of contractual agreements that may affect the financial statements. Answer (a) is incorrect because auditors do not ordinarily obtain a cost-benefit justification from management related to internal control weaknesses. Answer (b) is incorrect because written representations are not ordinarily obtained on such future plans. Answer (d) is incorrect because management may or may not be responsible for employee violations of laws, and because such a representation is not ordinarily obtained. See AU-C 580 for information on client representations.

120. (a) The requirement is to determine a matter to which materiality limits do **not** apply in obtaining written management representations. Answer (a) is correct because materiality considerations do not apply to management's acknowledgment of its responsibility for fair presentation of financial statements, the availability of all financial records, the completeness and availability of all minutes and meetings of stockholders, directors, and committees of directors, and communication from regulatory agencies. Answers (b), (c), and (d) are all incorrect because materiality considerations relate to losses from purchase commitments, compensating balances, and obsolete inventory. AU-C 580 discusses client representations.

121. (c) The requirement is to determine the proper date for a client's representation letter. AU-C 580 states that the representation letter should be dated as of the date of the auditor's report.

122. (b) The requirement is to identify the matter that an auditor **most** likely would include in a management representation letter. Auditors will generally request assurance as to the completeness and availability of minutes of stockholders' and directors' meetings. See AU-C 580 for written representations ordinarily obtained by the auditor.

123. (d) The requirement is to determine the year(s) on which a CPA must obtain written representations from management, when comparative financial statements are being issued, but current management has only been employed for a

portion of one of those years. AU-C 580 states that if current management was not present during all periods reported upon, the auditor should nevertheless obtain written representations from current management on all such periods.

124. (a) The requirement is to identify the information ordinarily included among the written client representations obtained by the auditor. Answer (a) is correct because AU-C 580 includes information on compensating balances in the list of representations normally obtained. Answer (b) is incorrect because management need not acknowledge a responsibility for employee illegal actions. Answer (c) is incorrect because the auditor, not the client, determines whether sufficient audit evidence has been made available. Answer (d) is incorrect because, for purposes of a financial statement audit, management need not attempt to determine whether material weaknesses in internal control exist.

125. (a) The requirement is to determine the correct statement with respect to the use of a management representation letter as audit evidence about the completeness assertion. Answer (a) is correct because such written representations are meant to complement, but not replace, substantive procedures. Answer (b) is incorrect because the complementary nature of such representations is **not** considered sufficient, even when combined with reliance upon internal control. The inherent limitations of internal control do not permit the auditor to **replace** substantive procedures with complete reliance on internal control. Answer (c) is incorrect because the written representations are considered complementary evidence in support of various assertions. Answer (d) is incorrect because such written representations are not considered to be replacements for reliance upon internal control.

126. (a) The requirement is to determine who should sign a letter of representation. AU-C 580 states that, normally, the chief executive officer and the chief financial officers should sign the letter of representation.

127. (d) The requirement is to identify the scope limitation which **in all cases** is sufficient to preclude an unqualified opinion. Answer (d) is correct because the professional standards state that management refusal to furnish written representations constitutes a limitation on the scope of the auditor's examination sufficient to preclude an unqualified opinion. Answer (a) is incorrect because management's refusal to allow the auditor to review the predecessor's work may not necessarily result in report modification. Answer (b) is incorrect because alternate procedures may be available that will make report modification unnecessary when the auditor has been engaged after completion of the year-end physical count. Answer (c) is incorrect because management may choose not to correct a significant deficiencies in internal control without a resulting limitation on the scope of the audit.

128. (c) The requirement is to identify a purpose of a management representation letter. Answer (c) is correct because a management representation letter is meant to reduce the possibility of a misunderstanding concerning management's responsibility for the financial statements. Answer (a) is incorrect because reducing audit risk to an aggregate level of misstatement that could be considered material is not a

logically sound statement. Answer (b) is incorrect because the management representation letter does not modify an auditor's responsibility to detect material misstatements. Answer (d) is incorrect because management representation letters are not a substitute for other procedures.

129. (c) The requirement is to identify the **most** likely source of a statement suggesting that there have been no communications from regulatory agencies. Answer (c) is correct because information such as this is ordinarily included in a management representation letter. Answers (a), (b), and (d) are incorrect because such a disclosure is not ordinarily included in a report on internal control, a special report, or a letter for an underwriter. See AU-C 580 for guidance on representation letters.

130. (d) The requirement is to identify which parties should reach an understanding on the limits of materiality for purposes of a lawyer's response to an auditor's inquiry concerning litigation, claims, and assessments. Answer (d) is correct because AU-C 501 states that a lawyer's response to an inquiry may be limited to material items, provided the lawyer and the auditor have reached an understanding on the limits of materiality for this purpose. Answer (a) is incorrect because it includes the client's management. Answer (b) is incorrect because it includes the client's audit committee and omits the auditor. Answer (c) is incorrect because it includes the client's management and omits the auditor.

131. (b) The requirement is to identify the correct statement concerning the refusal of a client's attorney to provide information requested in an inquiry letter. Answer (b) is correct because AU-C 501 indicates that this is a limitation on the scope of the audit. Answer (a) is incorrect because the lack of information is unlikely to lead to an adverse opinion since no information has been provided indicating that the financial statements are misstated. Answer (c) is incorrect because withdrawal is not generally necessary due to the client's attorney's failure to provide information. Answer (d) is incorrect because significant deficiencies pertain to weaknesses in internal control.

132. (c) The requirement is to identify the audit procedure that an auditor **most** likely would perform concerning litigation, claims, and assessments. Answer (c) is correct because auditors must discuss with management its policies and procedures for evaluating and accounting for litigation, claims and assessments. See AU-C 501 for this and other requirements. Answer (a) is incorrect because the client's lawyer is not ordinarily asked to make an assessment about whether the client has a going concern problem (see AU-C 570) for information on an auditor's consideration of a client's ability to continue as a going concern). Answer (b) is incorrect because an auditor will not ordinarily examine legal documents in the client's lawyer's possession. Answer (d) is incorrect because an auditor will not ordinarily confirm with the client's lawyer that all litigation, claims, and assessment have been recorded.

133. (b) The requirement is to identify the **primary** reason that an auditor should request a client to send a letter of inquiry to its attorneys. Answer (b) is correct because a

letter of audit inquiry to the client's attorney is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments. Answer (a) is incorrect because it will often be impossible to determine the probable outcome of asserted claims and pending or threatened litigation. Answer (c) is incorrect because no such opinions on historical experiences are generally available. Answer (d) is incorrect because the description of litigation, claims, and assessments is generally prepared by the client.

134. (b) The requirement is to identify the procedure that is **not** performed regarding litigation, claims, and assessments. Answer (b) is correct because the CPA does not confirm directly with the client's lawyer that all claims have been recorded in the financial statements. Answers (a), (c), and (d) are all incorrect because they represent information obtained from management regarding litigation, claims, and assessments as summarized in AU-C 501.

135. (a) The requirement is to identify the appropriate limitation for an attorney's response to a client's letter of audit inquiry. Answer (a) is correct because AU-C 501 states that an attorney may appropriately limit his response to matters to which s/he has given substantive attention in the form of legal consultation or representation. Answers (b), (c), and (d) are incorrect because AU-C 501 presents a variety of other requests in addition to information on the likelihood of an unfavorable outcome of the matters disclosed by the entity, similar litigation, and probable outcomes.

136. (a) If a client's lawyer resigned shortly after the receipt of an attorney's letter which indicated no significant disagreements with the client's assessment of contingent liabilities, the auditor should inquire why the attorney resigned. The auditor's concern is whether any undisclosed unasserted claims have arisen. Per AU-C 501, a lawyer may be required to resign if his advice concerning reporting for litigation, claims, and assessments is disregarded by the client. Accordingly, the resignation shortly after issuance of an attorney's letter may indicate a problem. Answer (b) is incorrect because the attorney issued a letter indicating no significant disagreement with the client's assessment of contingent liabilities. Answers (c) and (d) are incorrect because AU-C 501 only suggests that the auditor should consider the need for inquiries (i.e., AU-C 501) does not require a complete new exam of contingent liabilities or an adverse opinion).

137. (b) The requirement is to identify the lawyer's letter comment that is **most** likely to cause the auditor to request clarification. Answer (b) is correct because a statement that the action can be settled for less than the damages claimed is unclear as to the details of the attorney's belief. Answers (a), (c), and (d) are all incorrect because they represent responses that may be clearly interpreted by the auditor. See AU-C 501 for information on assessing lawyer's evaluations of the likely outcome of litigation.

138. (a) The requirement is to determine whether valuation issues arise at initial recording, subsequent to initial recording, or at both times when considering fair value of an asset or liability. Answer (a) is correct because AU-C 500 makes clear

that valuation issues arise at both times. Answers (b), (c), and (d) are all incorrect because they suggest that there are no valuation issues at one or both of these time periods.

139. (b) The requirement is to identify the **least** likely approach for auditing the fair values of assets and liabilities. Answer (b) is correct because it is doubtful that audit committee members will have information on the valuation.

Answers (a), (c), and (d) are all incorrect because they represent the three approaches presented for auditing fair values (as well as other estimates).

140. (c) The requirement is to identify the auditing procedure that would **most** likely assist an auditor in identifying related-party transactions. Answer (c) is correct because reviewing confirmations of loans receivable and payable for indications of guarantees may reveal unusual transactions that involve related parties. See AU-C 550 for procedures related to identifying transactions with related parties. Answer (a) is incorrect because inspecting the correspondence with lawyers for evidence of unreported contingent liabilities does not generally relate directly to related-party transactions. Answer (b) is incorrect because nonrecurring transactions are more indicative of related-party transactions. Answer (d) is incorrect because analytical procedures performed to identify possible financial difficulties do not relate directly to related-party transactions.

141. (c) The requirement is to determine an auditor's responsibility after having determined that a related-party transaction has occurred. Answer (c) is correct because after identifying the existence of such an act, the auditor should obtain an understanding of the business purpose of the transaction. See AU-C 550 for this and other responsibilities.

Answer (a) is incorrect because the mere existence of a related-party transaction may or may not lead to audit report modification. Answer (b) is incorrect because the performance of analytical procedures is not required. Answer (d) is incorrect because except for routine transactions, it will generally not be possible to determine whether the transaction would have taken place, or whether it was consummated on terms equivalent to an arm's-length transaction.

142. (d) The requirement is to identify the correct statement concerning related-party transactions. Answer (d) is correct because AU-C 550 requires that the auditor should place primary emphasis on the adequacy of disclosure. Answer (a) is incorrect because ascertaining rights and obligations is only part of the auditor's total responsibility and not the primary emphasis. Answer (b) is incorrect because while auditors attempt to determine the existence of related parties, this is not the primary emphasis. Answer (c) is incorrect because verifying the valuation of related-party transactions will often not be possible.

143. (d) The requirement is to identify the correct statement concerning related-party transactions. Answer (d) is correct because AU-C 550 requires that procedures directed toward identifying related-party transactions should be performed, even if the auditor has no reason to suspect their existence. Answer (a) is incorrect because, in the absence of evidence to the contrary, related-party transactions need not be assumed to be

outside the ordinary course of business. Answer (b) is incorrect because the auditor will not in general be able to determine whether a particular transaction would have occurred if the parties had **not** been related. Answer (c) is incorrect because, if proper disclosures are made, the related-party transactions are not required to be recorded on terms equivalent to arm's-length transactions.

144. (c) The requirement is to identify the circumstance in which an auditor **most** likely would modify an unqualified opinion if the entity's financial statements include a footnote on related-party transactions. Answer (c) is correct because it generally will not be possible to determine whether a particular transaction was consummated on terms equivalent to those with unrelated parties. Therefore, the auditor may be required to express a qualified or an adverse opinion when such an unsubstantiated disclosure is included. Answers (a), (b), and (d) are all incorrect because they represent situations that may be disclosed in related-party transaction disclosures.

145. (d) The requirement is to identify the **most** likely procedure to be performed in obtaining evidence about subsequent events. Answer (d) is correct because changes in long-term debt occurring after year-end may require note disclosure. Answers (a) and (b) are incorrect because auditors will not generally test changes in employee pay rates after year-end or recompute depreciation expense for plant assets sold. Answer (c) is incorrect because payroll checks issued near year-end may frequently be cashed after year-end and their investigation will not in general be directly related to obtaining evidence about subsequent events. See AU-C 560 for the responsibilities of auditors with respect to subsequent events.

146. (c) The requirement is to identify the event occurring after the issuance of an auditor's report that would **most** likely cause the auditor to make further inquiries about the previously issued financial statements. Answer (c) is correct because when an auditor becomes aware of information which relates to the financial statements previously reported upon, but which was not known at the date of the report, he or she should undertake to determine whether the information is reliable and whether the facts existed at the date of the audit report; in this circumstance it seems that the lease transactions existed as of the date of the audit report. Answer (a) is incorrect because the natural disaster occurred subsequent to the issuance of the audit report. Answer (b) is incorrect because the contingency had been properly disclosed. Answer (d) is incorrect because the sale of the subsidiary occurred subsequent to the issuance of the audit report.

147. (d) The requirement is to determine proper accounting and auditing treatment of uncollectibility of an account receivable resulting from a customer's bankruptcy due to a natural disaster occurring after a client's balance sheet date. Answer (d) is correct because a customer's major casualty loss after year-end will result in a financial statement note disclosure with no adjustment and no audit report modification due to consistency.

148. (d) The requirement is to determine an auditor's responsibility when subsequent to issuance of an audit report

a client sells the shares of a major subsidiary. Answer (d) is correct because no action need be taken since the event arose after the issuance of the auditor's report. Answers (a), (b), and (c) are all incorrect because they outline responsibilities which are not appropriate in this circumstance. See AU-C 560 for a discussion of auditor responsibility when subsequent to the issuance of the auditor's report the auditor becomes aware of a fact that **existed at the date of the auditor's report**.

149. (c) The requirement is to determine the auditor's responsibility with respect to a client acquisition of 25% of its outstanding capital stock after year-end and prior to the completion of the auditor's fieldwork. Answer (c) is correct because the transaction described is a type 2 subsequent event (since the acquisition provided evidence of a condition which came into existence after year-end) and therefore the proper accounting approach would be note disclosure rather than adjustment. Answer (a) is incorrect because adjustments are only appropriate for type 1 subsequent events (events which provide evidence that the condition was in existence at year-end). Answer (b) is incorrect because the auditor does not issue financial statements for the client. Answer (d) is incorrect because the opinion paragraph of the report need not be modified; if any report modification were considered necessary, it would be an explanatory paragraph emphasizing the matter.

150. (d) The requirement is to identify a procedure that an auditor would perform to obtain evidence about the occurrence of subsequent events. Answer (d) is correct because an auditor will inquire of officers and other executives having responsibility for financial and accounting matters whether any unusual adjustments have been made during the period from the balance sheet date to the date of inquiry. See AU-C 560 for auditing procedures performed to identify subsequent events.

151. (a) The requirement is to determine a procedure that an auditor should generally perform regarding subsequent events. Answer (a) is correct because the Professional Standards state that the auditor generally should compare the latest available interim financial statements with the financial statements being audited. See AU-C 560 (for this and other requirements. Answer (b) is incorrect because second accounts receivable confirmation requests will be sent well before the auditor's review of subsequent events. Answer (c) is incorrect because the communication of material weaknesses is not a subsequent event procedure. See AU-C 265 for the required communication of **significant deficiencies**. Answer (d) is incorrect because auditors generally only receive cutoff statements for the period immediately after year-end, not for multiple months.

152. (b) The requirement is to identify an auditor's responsibility when a client refuses to adjust recently issued financial statements for a subsequent event related to the bankruptcy of the entity's principal customer. Answer (b) is correct because if the client refuses to make disclosures, AU-C 560 requires the auditor to notify each member of the board of directors of such refusal and that he or she will take steps to prevent future reliance upon the audit report. Ordinarily the auditor will then

notify the clients and regulatory agencies that the report should no longer be associated with the financial statements, and when possible, notify persons known to be relying upon the financial statements. Answer (a) is incorrect because it is less likely that all of the creditors will be informed. Answer (c) is incorrect because the financial statements are the responsibility of management, and the auditor will not revise or distribute them. Answer (d) is incorrect because no revised report will be issued.

153. (c) The requirement is to identify the circumstance in which an auditor who finds that he or she has omitted a substantive procedure at the time of an audit may decide **not** to apply that procedure. Answer (c) is correct because when results of other procedures tend to compensate for the procedure it may be omitted. Answer (a) is incorrect because, even when distribution of the financial statement has been limited to management and the board of directors, it may be necessary to perform the procedure. Answer (b) is incorrect because the type of report issued does not affect the need to perform the procedure. Answer (d) is incorrect because delays by the client in providing data are not an acceptable reason not to perform that procedure.

154. (b) The requirement is to determine professional responsibility when, subsequent to issuance of an audit report, an auditor has determined that a necessary audit procedure has been omitted. Answer (b) is correct because an auditor must apply procedures that would provide a satisfactory basis for the opinion issued. Answer (a) is incorrect because stockholders need not be informed at this point that the audit report should **not** be relied upon. Answer (c) is incorrect because the auditor's report will not be reissued unless the financial statements are restated. Answer (d) is incorrect because tests of controls will not compensate for the omitted procedure. See AU-C 585 (390) for overall procedures relating to considering omitted procedures after an audit report has been issued.

155. (c) The requirement is to identify an auditor's first responsibility upon discovering six months after completion of an audit that engagement personnel failed to confirm several of the client's material accounts receivable balances. Answer (c) is correct because the auditor must first assess the importance of the omitted procedures to the auditor's ability to support the previously expressed opinion. Answers (a) and (b) are incorrect because prior to attempting any such confirmation or performing alternative procedures, an assessment of whether the procedures are needed is to be performed. Answer (d) is incorrect because a consideration of whether anyone is relying on, or is likely to rely on, the unqualified opinion is made after assessing the importance of the omitted procedure.

156. (d) The requirement is to determine the most likely approach for auditing the statement of cash flows. Answer (d) is correct because the statement of cash flows includes accounts considered during the audit of the balance sheet and income statements and, accordingly, the most frequent approach is to reconcile amounts. Answers (a), (b), and (c) are all incorrect because they suggest approaches not typically followed when auditing the statement of cash flows.

157. (c) The requirement is to determine the procedure **least** likely to be performed before the balance sheet date. Answer (c) is correct because the search for unrecorded liabilities relies upon a review of documents unrecorded at year-end, as well as inspection of purchases and disbursements recorded after year-end, to determine whether a proper cutoff of transactions between periods has occurred. Answer (a) is incorrect because auditors are able to test internal control over cash prior to year-end. Answers (b) and (d) are incorrect because in cases of good internal control, receivables may be confirmed and inventory observed prior to year-end.

158. (c) The requirement is to determine the **most** likely type of transaction that would be detected by an auditor's review of a client's sales cutoff. Answer (c) is correct because the auditor's review will include a study of sales recorded late in December and early in January. This will be accomplished by reviewing the period when the revenue was earned by shipment of goods or performance of services, as compared to the period in which the revenue was recorded. Accordingly, the review of sales recorded in January may reveal unrecorded sales for the preceding year. Answer (a) is incorrect because shipments lacking sales invoices and shipping documents will be very difficult to identify; also, this reply is more limited than answer (c). Answer (b) is incorrect because excessive write-offs of accounts receivable will not usually be detected when testing the sales cutoff. Answer (d) is incorrect because it is unlikely that lapping in the application of cash receipts will be detected by sales cutoff testing. More frequently, procedures such as confirmations, analytical procedures, and an analysis of deposit tickets reveal lapping.

159. (b) The requirement is to identify the assertion being tested by cutoff tests designed to detect credit sales made before the end of the year that have improperly been recorded in the subsequent year. Answer (b) is correct because the completeness assertion deals with whether all transactions have been included in the proper period. Answer (a) is incorrect because the presentation or disclosure assertion deals with whether particular components of the financial statements are properly classified, described, and disclosed. Answer (c) is incorrect because the rights and obligations assertion deals with whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. Answer (d) is incorrect because the existence or occurrence assertion deals with whether assets or liabilities of the entity exist at a given

date and whether recorded transactions have occurred during a given period. In this question, the existence assertion would be tested if the auditor sampled from sales recorded prior to year-end to determine whether the sale occurred before or after year-end.

160. (d) The requirement is to identify the procedure an auditor would **most** likely perform during the overall review stage of formulating an opinion on an entity's financial statements. Answer (d) is correct because a consideration of results relating to the assessment of the risk of material misstatement due to fraud may reveal that the audit has inadequately addressed that risk; in such a case additional procedures would be required. Answer (a) is incorrect because such assurance from the entity's attorney is ordinarily obtained prior to the overall review stage of an audit. Answer (b) is incorrect because the verification of the accuracy of the proof of cash is ordinarily performed prior to the overall review and because little verification of the bank cutoff statement is usually necessary since it is ordinarily received directly by the auditor from the bank. Answer (c) is incorrect because such provisions for the safeguarding of assets may be corrected well after the conclusion of the audit.

161. (a) The requirement is to identify the correct statement with respect to the **primary** orientation of operational auditing. Answer (a) is correct because operational audits deal primarily with evaluating the efficiency and effectiveness with which operations function, often with the intention of making improvements to accomplish the goals of management. Answers (b) and (c) are incorrect because financial statement audits are oriented toward such determinations, not operational audits. Answer (d) is incorrect because examinations of internal control are not performed on operational audits.

162. (d) The requirement is to identify a typical objective of an operational audit. Answer (d) is correct because operational audits typically address efficiency and effectiveness. Answer (a) is incorrect because while the adequacy of internal control design may be addressed during an operational audit, this is less complete than answer (d). Answer (b) is incorrect because operational audits may or may not be related to compliance with generally accepted governmental auditing standards. Answer (c) is incorrect because financial statement audits, not operational audits, address whether results of operations are fairly presented.

Multiple-Choice Questions (1–207)

A. Audit Reports: Standard Unmodified Reports

1. The existence of audit risk is recognized by the statement in the auditor's standard report that the auditor
 - a. Obtains reasonable assurance about whether the financial statements are free of material misstatement.
 - b. Assesses the accounting principles used and also evaluates the overall financial statement presentation.
 - c. Realizes some matters, either individually or in the aggregate, are important while other matters are not important.
 - d. Is responsible for expressing an opinion on the financial statements, which are the responsibility of management.
2. When an accountant performs more than one level of service (for example, a compilation and a review, or a compilation and an audit) concerning the financial statements of a nonissuer (nonpublic) entity, the accountant generally should issue the report that is appropriate for
 - a. The lowest level of service rendered.
 - b. The highest level of service rendered.
 - c. A compilation engagement.
 - d. A review engagement.
3. March, CPA, is engaged by Monday Corp., a client, to audit the financial statements of Wall Corp., a company that is not March's client. Monday expects to present Wall's audited financial statements with March's auditor's report to 1st Federal Bank to obtain financing in Monday's attempt to purchase Wall. In these circumstances, March's auditor's report would usually be addressed to
 - a. Monday Corp., the client that engaged March.
 - b. Wall Corp., the entity audited by March.
 - c. 1st Federal Bank.
 - d. Both Monday Corp. and 1st Federal Bank.
4. Which of the following statements is a basic element of the auditor's standard report on financial statements?
 - a. The disclosures provide reasonable assurance that the financial statements are free of material misstatement.
 - b. The auditor evaluated the overall internal control and provides limited assurance on it.
 - c. An audit includes assessing significant estimates made by management.
 - d. The financial statements are consistent with those of the prior period.
5. For a nonpublic company, which section (paragraph) of the audit report includes a statement that the auditor believes that the audit evidence obtained is sufficient?
 - a. Introductory.
 - b. Opinion.
 - c. Auditor's responsibility.
 - d. Management's responsibility.
6. For a nonpublic company audit report, a statement that the auditor has audited the financial statements followed by the titles of the financial statements is included in the
 - a. Management's responsibility section of the audit report.
 - b. The opening paragraph of the auditor's standard report.
 - c. The auditor's responsibility section of the audit report.
 - d. The opinion paragraph of the auditor's standard report.
7. How does an auditor make the following representations when issuing the standard public company auditor's report on comparative financial statements?

	Examination of evidence on a test basis	Consistent application of accounting principles
a.	Explicitly	Explicitly
b.	Implicitly	Implicitly
c.	Implicitly	Explicitly
d.	Explicitly	Implicitly
8. Which of the following **best** describes the reference to the expression "taken as a whole" in the PCAOB's audit reporting standards?
 - a. They apply equally to a complete set of financial statements and to each individual financial statement.
 - b. They apply only to a complete set of financial statements.
 - c. They apply equally to each item in each financial statement.
 - d. They apply equally to each material item in each financial statement.
9. A financial statement audit report issued for the audit of an issuer (public) company concludes that the financial statements follow
 - a. Generally accepted accounting principles.
 - b. Public Company Accounting Oversight Board standards.
 - c. Generally accepted auditing standards.
 - d. International accounting standards.
10. Which of the following is **not** correct concerning information included in an audit report of financial statements issued under the requirements of the Public Company Accounting Oversight Board?
 - a. The report should include the title "Report of Independent Registered Public Accounting Firm."
 - b. The report should refer to the standards of the PCAOB.
 - c. The report should include a paragraph referring to the auditor's report on compliance with laws and regulations.
 - d. The report should contain the city and state or country of the office that issued the report.

B.2. Substantial Doubt about Ability to Continue as a Going Concern

11. An auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. If the entity's financial statements adequately disclose its financial difficulties, the auditor's report is required to include an emphasis-of-matter paragraph that specifically uses the phrase(s)

	"Reasonable period of time, not to exceed 1 year"	"Going concern"
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

12. Mead, CPA, had substantial doubt about Tech Co.'s ability to continue as a going concern when reporting on Tech's audited financial statements for the year ended June 30, 20X1. That doubt has been removed in 20X2. What is Mead's reporting responsibility if Tech is presenting its financial statements for the year ended June 30, 20X2, on a comparative basis with those of 20X1?

- The emphasis-of-matter paragraph included in the 20X1 auditor's report should not be repeated.
- The emphasis-of-matter paragraph included in the 20X1 auditor's report should be repeated in its entirety.
- A different emphasis-of-matter paragraph describing Mead's reasons for the removal of doubt should be included.
- A different emphasis-of-matter paragraph describing Tech's plans for financial recovery should be included.

13. When an auditor concludes there is substantial doubt about a continuing audit client's ability to continue as a going concern for a reasonable period of time, the auditor's responsibility is to

- Issue a qualified or adverse opinion, depending upon materiality, due to the possible effects on the financial statements.
- Consider the adequacy of disclosure about the client's possible inability to continue as a going concern.
- Report to the client's audit committee that management's accounting estimates may need to be adjusted.
- Reissue the prior year's auditor's report and add an emphasis-of-matter paragraph that specifically refers to "substantial doubt" and "going concern."

14. Green, CPA, concludes that there is substantial doubt about JKL Co.'s ability to continue as a going concern. If JKL's financial statements adequately disclose its financial difficulties, Green's auditor's report should

	Include an emphasis-of-matter paragraph following the opinion paragraph	Specifically use the words "going concern"	Specifically use the words "substantial doubt"
a.	Yes	Yes	Yes
b.	Yes	Yes	No
c.	Yes	No	Yes
d.	No	Yes	Yes

15. In which of the following circumstances would an auditor **most** likely add an emphasis-of-matter paragraph to the audit report while **not** affecting the auditor's unmodified opinion?

- The auditor is asked to report on the balance sheet, but not on the other basic financial statements.
- There is substantial doubt about the entity's ability to continue as a going concern.
- Management's estimates of the effects of future events are unreasonable.
- Certain transactions cannot be tested because of management's records retention policy.

16. After considering an entity's negative trends and financial difficulties, an auditor has substantial doubt about the entity's ability to continue as a going concern. The auditor's considerations relating to management's plans for dealing with the adverse effects of these conditions **most** likely would include management's plans to

- Increase current dividend distributions.
- Reduce existing lines of credit.
- Increase ownership equity.
- Purchase assets formerly leased.

17. Which of the following conditions or events **most** likely would cause an auditor to have substantial doubt about an entity's ability to continue as a going concern?

- Significant related-party transactions are pervasive.
- Usual trade credit from suppliers is denied.
- Arrearages in preferred stock dividends are paid.
- Restrictions on the disposal of principal assets are present.

18. Cooper, CPA, believes there is substantial doubt about the ability of Zero Corp. to continue as a going concern for a reasonable period of time. In evaluating Zero's plans for dealing with the adverse effects of future conditions and events, Cooper most likely would consider, as a mitigating factor, Zero's plans to

- Discuss with lenders the terms of all debt and loan agreements.
- Strengthen controls over cash disbursements.
- Purchase production facilities currently being leased from a related party.
- Postpone expenditures for research and development projects.

19. Which of the following conditions or events **most** likely would cause an auditor to have substantial doubt about an entity's ability to continue as a going concern?

- a. Cash flows from operating activities are negative.
- b. Research and development projects are postponed.
- c. Significant related-party transactions are pervasive.
- d. Stock dividends replace annual cash dividends.

20. Which of the following auditing procedures **most** likely would assist an auditor in identifying conditions and events that may indicate substantial doubt about an entity's ability to continue as a going concern?

- a. Inspecting title documents to verify whether any assets are pledged as collateral.
- b. Confirming with third parties the details of arrangements to maintain financial support.
- c. Reconciling the cash balance per books with the cut-off bank statement and the bank confirmation.
- d. Comparing the entity's depreciation and asset capitalization policies to other entities in the industry.

21. Which of the following audit procedures would **most** likely assist an auditor in identifying conditions and events that may indicate there could be substantial doubt about an entity's ability to continue as a going concern?

- a. Review compliance with the terms of debt agreements.
- b. Confirmation of accounts receivable from principal customers.
- c. Reconciliation of interest expense with debt outstanding.
- d. Confirmation of bank balances.

22. Davis, CPA, believes there is substantial doubt about the ability of Hill Co. to continue as a going concern for a reasonable period of time. In evaluating Hill's plans for dealing with the adverse effects of future conditions and events, Davis **most** likely would consider, as a mitigating factor, Hill's plans to

- a. Accelerate research and development projects related to future products.
- b. Accumulate treasury stock at prices favorable to Hill's historic price range.
- c. Purchase equipment and production facilities currently being leased.
- d. Negotiate reductions in required dividends being paid on preferred stock.

23. The adverse effects of events causing an auditor to believe there is substantial doubt about an entity's ability to continue as a going concern would **most** likely be mitigated by evidence relating to the

- a. Ability to expand operations into new product lines in the future.
- b. Feasibility of plans to purchase leased equipment at less than market value.
- c. Marketability of assets that management plans to sell.
- d. Committed arrangements to convert preferred stock to long-term debt.

B.3. Inconsistency in Application of GAAP

24. For which of the following events would an auditor issue a report that omits any reference to consistency?

- a. A change in the method of accounting for inventories.
- b. A change from an accounting principle that is **not** generally accepted to one that is generally accepted.
- c. A change in the useful life used to calculate the provision for depreciation expense.
- d. Management's lack of reasonable justification for a change in accounting principle.

25. An auditor would express an unmodified opinion and add an emphasis-of-matter paragraph for

	An unjustified accounting change	A material weakness in the internal control
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

26. Under which of the following circumstances would a disclaimer of opinion **not** be appropriate?

- a. The auditor is unable to determine the amounts associated with an employee fraud scheme.
- b. Management does **not** provide reasonable justification for a change in accounting principles.
- c. The client refuses to permit the auditor to confirm certain accounts receivable or apply alternative procedures to verify their balances.
- d. The chief executive officer is unwilling to sign the management representation letter.

27. Digit Co. uses the FIFO method of costing for its international subsidiary's inventory and LIFO for its domestic inventory. Under these circumstances, the auditor's report on Digit's financial statements should express an

- a. Unmodified opinion.
- b. Opinion qualified because of a lack of consistency.
- c. Opinion qualified because of a departure from GAAP.
- d. Adverse opinion.

28. In the first audit of a new client, an auditor was able to extend auditing procedures to gather sufficient evidence about consistency. Under these circumstances, the auditor should

- a. Not report on the client's income statement.
- b. Not refer to consistency in the auditor's report.
- c. State that the consistency standard does **not** apply.
- d. State that the accounting principles have been applied consistently.

29. When management does **not** provide reasonable justification that a change in accounting principle is preferable and it presents comparative financial statements, the auditor should express a qualified opinion

- a. Only in the year of the accounting principle change.
- b. Each year that the financial statements initially reflecting the change are presented.

- c. Each year until management changes back to the accounting principle formerly used.
- d. Only if the change is to an accounting principle that is not generally accepted.

30. When an entity changes its method of accounting for income taxes, which has a material effect on comparability, the auditor should refer to the change in an emphasis-of-matter paragraph added to the auditor's report. This paragraph should identify the nature of the change and

- a. Explain why the change is justified under generally accepted accounting principles.
- b. Describe the cumulative effect of the change on the audited financial statements.
- c. State the auditor's explicit concurrence with or opposition to the change.
- d. Refer to the financial statement note that discusses the change in detail.

31. An entity changed from the straight-line method to the declining balance method of depreciation for all newly acquired assets. This change has no material effect on the current year's financial statements, but is reasonably certain to have a substantial effect in later years. If the change is disclosed in the notes to the financial statements, the auditor should issue a report with a(n)

- a. "Except for" qualified opinion.
- b. Emphasis-of-matter paragraph.
- c. Unmodified opinion.
- d. Consistency modification.

B.4. Uncertainties

32. An uncertainty facing the firm relating to the possible future results of litigation filed against client is **most** likely to result in which of the following types of audit report?

- a. Adverse with a basis for adverse opinion paragraph.
- b. Qualified due to a scope limitation.
- c. Qualified with a basis for qualification paragraph.
- d. Unqualified with emphasis-of-matter paragraph.

B.5. Other Circumstances at the Discretion of the Auditor

33. Wilson, CPA, completed gathering sufficient appropriate audit evidence for the audit of Abco's December 31, 20X8 financial statements on March 6, 20X9. A subsequent event requiring adjustment to the 20X8 financial statements occurred on April 10, 20X9 and came to Wilson's attention on April 24, 20X9. If the adjustment is made without disclosure of the event, Wilson's report ordinarily should be dated

- a. March 6, 20X9.
- b. April 10, 20X9.
- c. April 24, 20X9.
- d. Using dual dating.

34. An auditor issued an audit report that was dual dated for a subsequent event occurring after the completion of

fieldwork but before issuance of the auditor's report. The auditor's responsibility for events occurring subsequent to the completion of fieldwork was

- a. Extended to subsequent events occurring through the date of issuance of the report.
- b. Extended to include all events occurring since the completion of fieldwork.
- c. Limited to the specific event referenced.
- d. Limited to include only events occurring up to the date of the last subsequent event referenced.

35. An auditor includes a separate paragraph in an otherwise unmodified report to emphasize that the entity being reported on had significant transactions with related parties. The inclusion of this separate paragraph

- a. Is considered an "except for" qualification of the opinion.
- b. Violates generally accepted auditing standards if this information is already disclosed in footnotes to the financial statements.
- c. Necessitates a revision of the opinion paragraph to include the phrase "with the foregoing explanation."
- d. Is appropriate and would not negate the unmodified opinion.

C.1. Circumstances Resulting in Audit Reports with Modified Opinions—Background

36. Which of the following phrases should be included in the opinion paragraph when an auditor expresses a qualified opinion?

	When read in conjunction with Note X	With the foregoing explanation
a.	Yes	No
b.	No	Yes
c.	Yes	Yes
d.	No	No

37. An auditor may **not** issue a qualified opinion when

- a. An accounting principle at variance with GAAP is used.
- b. The auditor lacks independence with respect to the audited entity.
- c. A scope limitation prevents the auditor from completing an important audit procedure.
- d. The auditor's report refers to the work of a specialist.

C.2. Materially Misstated Financial Statements (Departures from GAAP)

38. When an auditor expresses an adverse opinion, the opinion paragraph should include

- a. The principal effects of the departure from generally accepted accounting principles.
- b. A direct reference to a separate paragraph disclosing the basis for the opinion.

- c. The substantive reasons for the financial statements being misleading.
- d. A description of the uncertainty or scope limitation that prevents an unmodified opinion.

39. An auditor concludes that a client's illegal act, which has a material effect on the financial statements, has not been properly accounted for or disclosed. Depending on the materiality of the effect on the financial statements, the auditor should express either a(n)

- a. Adverse opinion or a disclaimer of opinion.
- b. Qualified opinion or an adverse opinion.
- c. Disclaimer of opinion or an unmodified opinion with a separate emphasis-of-matter paragraph.
- d. Unmodified opinion with a separate emphasis-of-matter paragraph or a qualified opinion.

40. Which of the following phrases would an auditor **most** likely include in the auditor's report when expressing a qualified opinion because of inadequate disclosure?

- a. Subject to the departure from US generally accepted accounting principles, as described above.
- b. With the foregoing explanation of these omitted disclosures.
- c. Except for the omission of the information discussed in the preceding paragraph.
- d. Does not present fairly in all material respects.

41. In which of the following circumstances would an auditor be **most** likely to express an adverse opinion?

- a. The chief executive officer refuses the auditor access to minutes of board of directors' meetings.
- b. Tests of controls show that the entity's internal control is so poor that it **cannot** be relied upon.
- c. The financial statements are **not** in conformity with a FASB requirement regarding the capitalization of leases.
- d. Information comes to the auditor's attention that raises substantial doubt about the entity's ability to continue as a going concern.

42. When an auditor qualifies an opinion because of inadequate disclosure, the auditor should describe the nature of the omission in a basis for qualification paragraph and modify the

	Introductory paragraph	Auditor responsibility paragraphs	Opinion paragraph
a.	Yes	No	No
b.	Yes	Yes	No
c.	No	Yes	Yes
d.	No	No	Yes

43. If a publicly held company issues financial statements that purport to present its financial position and results of operations but omits the statement of cash flows, which of the following types of opinion is **most** likely to be appropriate?

- a. Disclaimer of opinion.
- b. Qualified opinion.
- c. Review report with negative assurance.

- d. Unmodified opinion with a separate emphasis-of-matter paragraph.

44. In which of the following situations would an auditor ordinarily choose between expressing an "except for" qualified opinion or an adverse opinion?

- a. The auditor did not observe the entity's physical inventory and is unable to become satisfied as to its balance by other auditing procedures.
- b. The financial statements fail to disclose information that is required by generally accepted accounting principles.
- c. The auditor is asked to report only on the entity's balance sheet and not on the other basic financial statements.
- d. Events disclosed in the financial statements cause the auditor to have substantial doubt about the entity's ability to continue as a going concern.

45. In which of the following situations would an auditor ordinarily choose between expressing a qualified opinion or an adverse opinion?

- a. The auditor did not observe the entity's physical inventory and is unable to become satisfied about its balance by other auditing procedures.
- b. Conditions that cause the auditor to have substantial doubt about the entity's ability to continue as a going concern are inadequately disclosed.
- c. There has been a change in accounting principles that has a material effect on the comparability of the entity's financial statements.
- d. The auditor is unable to apply necessary procedures concerning an investor's share of an investee's earnings recognized on the equity method.

C.3. Inability to Obtain Sufficient Appropriate Audit Evidence (Scope Limitations)

46. In the first audit of a client, an auditor was not able to gather sufficient evidence about the consistent application of accounting principles between the current and the prior year, as well as the amounts of assets or liabilities at the beginning of the current year. This was due to the client's record retention policies. If the amounts in question could materially affect current operating results, the auditor would

- a. Be unable to express an opinion on the current year's results of operations and cash flows.
- b. Express a qualified opinion on the financial statements because of a client-imposed scope limitation.
- c. Withdraw from the engagement and refuse to be associated with the financial statements.
- d. Specifically state that the financial statements are not comparable to the prior year due to an uncertainty.

47. In which of the following circumstances would an auditor **not** express an unmodified opinion?

- a. There has been a material change between periods in accounting principles.

- b. Quarterly financial data required by the SEC has been omitted.
- c. The auditor wishes to emphasize an unusually important subsequent event.
- d. The auditor is unable to obtain audited financial statements of a consolidated investee.

48. Due to a scope limitation, an auditor disclaimed an opinion on the financial statements taken as a whole, but the auditor's report included a statement that the current asset portion of the entity's balance sheet was fairly stated. The inclusion of this statement is

- a. Not appropriate because it may tend to overshadow the auditor's disclaimer of opinion.
- b. Not appropriate because the auditor is prohibited from reporting on only one basic financial statement.
- c. Appropriate provided the auditor's scope paragraph adequately describes the scope limitation.
- d. Appropriate provided the statement is in a separate paragraph preceding the disclaimer of opinion paragraph.

49. Park, CPA, was engaged to audit the financial statements of Tech Co., a new client, for the year ended December 31, 2009. Park obtained sufficient audit evidence for all of Tech's financial statement items except Tech's opening inventory. Due to inadequate financial records, Park could not verify Tech's January 1, 2009 inventory balances. Park's opinion on Tech's 2009 financial statements **most** likely will be

	Balance sheet	Income statement
a.	Disclaimer	Disclaimer
b.	Unmodified	Disclaimer
c.	Disclaimer	Adverse
d.	Unmodified	Adverse

50. An auditor who qualifies an opinion because of an insufficiency of audit evidence should describe the limitations in a basis for modification paragraph. The auditor should also refer to the limitation in the

	Auditor's responsibility section	Opinion paragraph	Notes to the financial statements
a.	Yes	No	Yes
b.	No	Yes	No
c.	Yes	Yes	No
d.	Yes	Yes	Yes

51. Harris, CPA, has been asked to audit and report on the balance sheet of Fox Co. but not on the statements of income, retained earnings, or cash flows. Harris will have access to all information underlying the basic financial statements. Under these circumstances, Harris may

- a. Not accept the engagement because it would constitute a violation of the profession's ethical standards.
- b. Not accept the engagement because it would be tantamount to rendering a piecemeal opinion.
- c. Accept the engagement because such engagements merely involve limited reporting objectives.

- d. Accept the engagement but should disclaim an opinion because of an inability to apply the procedures considered necessary.

52. When disclaiming an opinion due to a client-imposed scope limitation on a nonpublic company's financial statements, an auditor should indicate in a separate paragraph why the audit did not comply with generally accepted auditing standards. The auditor should also omit which of the two sections (paragraphs) below?

	Auditor responsibility	Opinion
a.	No	Yes
b.	Yes	Yes
c.	Yes	No
d.	No	No

53. An auditor decides to issue a qualified opinion on an entity's financial statements because a major inadequacy in its computerized accounting records prevents the auditor from applying necessary procedures. The opinion paragraph of the auditor's report should state that the qualification pertains to

- a. A client-imposed scope limitation.
- b. A departure from generally accepted auditing standards.
- c. The possible effects on the financial statements.
- d. Inadequate disclosure of necessary information.

54. A scope limitation sufficient to preclude an unmodified opinion always will result when management

- a. Prevents the auditor from reviewing the working papers of the predecessor auditor.
- b. Engages the auditor after the year-end physical inventory is completed.
- c. Requests that certain material accounts receivable **not** be confirmed.
- d. Refuses to acknowledge its responsibility for the fair presentation of the financial statements in conformity with GAAP.

55. An auditor concludes that extreme doubt exists about the integrity of management and the representations obtained from management relating to the fairness of the financial statements and the completeness of the record of transactions. If the auditor retains the client, which audit report is **most** likely to be appropriate?

- a. Unmodified with emphasis-of-matter paragraph.
- b. Standard unmodified.
- c. Disclaimer.
- d. Adverse

D. Group Financial Statements

56. In which of the following situations would an auditor ordinarily issue an unmodified audit opinion without an emphasis-of-matter paragraph?

- a. The auditor wishes to emphasize that the entity had significant related-party transactions.

- b. The auditor decides to make reference to the report of an auditor who audited a component of group financial statements.
- c. The entity issues financial statements that present financial position and results of operations, but omits the statement of cash flows.
- d. The auditor has substantial doubt about the entity's ability to continue as a going concern, but the circumstances are fully disclosed in the financial statements.

57. A group engagement partner decides not to refer to the audit of another CPA who audited a component of the overall group financial statements. After making inquiries about the other CPA's professional reputation and independence, the principal auditor **most** likely would

- a. Add an emphasis-of-matter paragraph to the auditor's report indicating that the subsidiary's financial statements are not material to the consolidated financial statements.
- b. Document in the engagement letter that the principal auditor assumes no responsibility for the other CPA's work and opinion.
- c. Obtain written permission from the other CPA to omit the reference in the principal auditor's report.
- d. Perform additional audit procedures based on the significance of the subsidiary.

58. The auditor's responsibility section of a nonpublic company's auditor's report contains the following sentences:

We did not audit the financial statements of EZ Inc., a wholly owned subsidiary, which statements reflect total assets and revenues constituting 27% and 29%, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for EZ Inc., is based solely on the report of the other auditors.

These sentences

- a. Indicate a division of responsibility.
- b. Assume responsibility for the other auditor.
- c. Require a departure from an unmodified opinion.
- d. Are an improper form of reporting.

59. An auditor may issue the standard audit report when the

- a. Auditor refers to the findings of a specialist.
- b. Financial statements are derived and summarized from complete audited financial statements that are filed with a regulatory agency.
- c. Financial statements are prepared on the cash receipts and disbursements basis of accounting.
- d. Group engagement partner assumes responsibility for the work of a component auditor.

60. In the auditor's report, the group engagement partner decides not to make reference to a component auditor who audited a client's subsidiary. The group engagement partner could justify this decision if, among other requirements, he or she

- a. Issues an unmodified opinion on the consolidated financial statements.

- b. Learns that the component auditor issued an unmodified opinion on the subsidiary's financial statements.
- c. Is unable to review the audit plan (programs) and working papers of the component auditor.
- d. Is satisfied as to the independence and professional reputation of the other CPA.

61. When financial statements of a company that follows GASB standards would be misleading due to unusual circumstances depart from those standards, the auditor should explain the unusual circumstances in a separate paragraph and express an opinion that is

- a. Unmodified.
- b. Qualified.
- c. Adverse.
- d. Qualified or adverse, depending on materiality.

62. A client follows US GAAP for its domestic operations and foreign GAAP for a foreign subsidiary. The foreign subsidiary is audited by a component auditor, while the group auditor audits the remainder of the corporation and issues an audit report on consolidated operations. Which auditor(s) is (are) responsible for evaluating the appropriateness of the adjustment of the foreign GAAP statements to US GAAP?

	Group auditor	Component auditor
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

E.2. Comparative Financial Statements

63. In May 20X9, an auditor reissues the auditor's report on the 20X7 financial statements at a continuing client's request. The 20X7 financial statements are not restated and the auditor does not revise the wording of the report. The auditor should

- a. Dual date the reissued report.
- b. Use the release date of the reissued report.
- c. Use the original report date on the reissued report.
- d. Use the current period auditor's report date on the reissued report.

64. When reporting on comparative financial statements, an auditor ordinarily should change the previously issued opinion on the prior year's financial statements if the

- a. Prior year's financial statements are restated to conform with generally accepted accounting principles.
- b. Auditor is a predecessor auditor who has been requested by a former client to reissue the previously issued report.
- c. Prior year's opinion was unmodified and the opinion on the current year's financial statements is modified due to a lack of consistency.
- d. Prior year's financial statements are restated following a pooling of interests in the current year.

65. Jewel, CPA, audited Infinite Co.'s prior year financial statements. These statements are presented with those of the

current year for comparative purposes without Jewel's auditor's report, which expressed a qualified opinion. In drafting the current year's auditor's report, Crain, CPA, the successor auditor, should

- I. Not name Jewel as the predecessor auditor.
- II. Indicate the type of report issued by Jewel.
- III. Indicate the substantive reasons for Jewel's qualification.

- a. I only.
- b. I and II only.
- c. II and III only.
- d. I, II, and III.

66. Before reissuing the prior year's auditor's report on the financial statements of a former client, the predecessor auditor should obtain a letter of representations from the

	Former client's management	Successor auditor
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

67. When single-year financial statements are presented, an auditor ordinarily would express a standard audit report if the

- a. Auditor is unable to obtain audited financial statements supporting the entity's investment in a foreign affiliate.
- b. Entity declines to present a statement of cash flows with its balance sheet and related statements of income and retained earnings.
- c. Auditor wishes to emphasize an accounting matter affecting the comparability of the financial statements with those of the prior year.
- d. Prior year's financial statements were audited by another CPA whose report, which expressed an unmodified opinion, is not presented.

68. A client is presenting comparative (two-year) financial statements. Which of the following is correct concerning reporting responsibilities of a continuing auditor?

- a. The auditor should issue one audit report that is on both presented years.
- b. The auditor should issue two audit reports, one on each year.
- c. The auditor should issue one audit report, but only on the most recent year.
- d. The auditor may issue either one audit report on both presented years, or two audit reports, one on each year.

69. The predecessor auditor, who is satisfied after properly communicating with the successor auditor, has reissued a report because the audit client desires comparative financial statements. The predecessor auditor's report for a nonpublic company should make

- a. Reference to the report of the successor auditor only in another matter paragraph.

- b. Reference to the work of the successor auditor in an other matter paragraph and in the opinion paragraph.
- c. Reference to both the work and the report of the successor auditor only in the opinion paragraph.
- d. No reference to the report or the work of the successor auditor.

70. Compiled financial statements for the prior year presented in comparative form with audited financial statements for the current year should be clearly marked to indicate their status and

- I. The report on the prior period should be reissued to accompany the current period report.
 - II. The report on the current period should include as a separate paragraph a description of the responsibility assumed for the prior period's financial statements.
- a. I only.
 - b. II only.
 - c. Both I and II.
 - d. Either I or II.

E.3. Other Information in Documents Containing Audited Financial Statements

71. An auditor concludes that there is a material inconsistency in the other information in an annual report to shareholders containing audited financial statements. If the auditor concludes that the financial statements do **not** require revision, but the client refuses to revise or eliminate the material inconsistency, the auditor may

- a. Revise the auditor's report to include a separate emphasis-of-matter paragraph describing the material inconsistency.
- b. Issue an "except for" qualified opinion after discussing the matter with the client's board of directors.
- c. Consider the matter closed since the other information is **not** in the audited financial statements.
- d. Disclaim an opinion on the financial statements after explaining the material inconsistency in a separate basis for disclaimer paragraph.

72. When audited financial statements are presented in a client's document containing other information, the auditor should

- a. Perform inquiry and analytical procedures to ascertain whether the other information is reasonable.
- b. Add an emphasis-of-matter paragraph to the auditor's report without changing the opinion on the financial statements.
- c. Perform the appropriate substantive auditing procedures to corroborate the other information.
- d. Read the other information to determine that it is consistent with the audited financial statements.

73. An auditor may express an opinion on an entity's accounts receivable balance even if the auditor has disclaimed an opinion on the financial statements taken as a whole provided the

- a. Report on the accounts receivable discloses the reason for the disclaimer of opinion on the financial statements.

- b. Distribution of the report on the accounts receivable is restricted to internal use only.
- c. Auditor also reports on the current asset portion of the entity's balance sheet.
- d. Report on the accounts receivable is presented separately from the disclaimer of opinion on the financial statements.

E.4. Required Supplementary Information

74. In an audit of a nonissuer company, which statement is correct concerning required supplementary information by a designated accounting standards setter?

- a. The auditor has no responsibility for required supplementary information as long as it is outside the basic financial statements.
- b. The auditor's only responsibility for required supplementary information is to determine that such information has **not** been omitted.
- c. The auditor should apply certain limited procedures to the required supplementary information, and report deficiencies in, or omissions of, such information.
- d. The auditor should apply tests of details of transactions and balances to the required supplementary information, and report any material misstatements in such information.

75. If management declines to present supplementary information required by the Governmental Accounting Standards Board (GASB), the auditor should issue a(n)

- a. Adverse opinion.
- b. Qualified opinion with an other-matter paragraph.
- c. Unmodified opinion.
- d. Unmodified opinion with an additional other-matter paragraph.

E.5. Supplementary Information in Relation to the Financial Statements as a Whole

76. If an auditor is asked to provide an opinion relating to information accompanying the financial statements in a document, the opinion will ordinarily be upon whether the information is fairly stated in

- a. Accordance with US generally accepted auditing standards.
- b. Conformity with US generally accepted accounting principles.
- c. All material respects in relation to the basic financial statements taken as a whole.
- d. Accordance with attestation standards expressing a conclusion about management's assertions.

E.6. Alerts as to Report Intended Use (Restricting the Use of an Auditor's Report)

77. Which of the following statements is correct concerning an auditor's responsibility for controlling the **distribution by the client** of a restricted-use report?

- a. An auditor must make clear to the client that it is illegal to distribute such a report beyond to specified parties.

- b. When an auditor is aware that a client has distributed a restricted-use report to inappropriate third parties, the auditor should immediately inform the client to cease and desist.
- c. An auditor controls distribution through insisting that the client not duplicate the restricted-use report for any purposes.
- d. An auditor is not responsible for controlling the distribution of such reports.

78. Which of the following types of reports is **most** likely to include an alert as to its use being restricted to certain specified parties?

- a. Audit report.
- b. Review report.
- c. Compilation report.
- d. Agreed-upon procedures report.

79. Which of the following is **least** likely to be a restricted use report?

- a. A report on internal control significant deficiencies noted in an audit.
- b. A required communication with the audit committee.
- c. A report on financial statements prepared following a financial reporting framework other than generally accepted accounting principles.
- d. A report on compliance with aspects of contractual agreements.

E.7. Additional Circumstances Involving Other-Matter Paragraphs

80. An auditor expressed a qualified opinion on the prior year's financial statements because of a lack of adequate disclosure. These financial statements are properly restated in the current year and presented in comparative form with the current year's financial statements. The auditor's updated report on the prior year's financial statements should

- a. Be accompanied by the auditor's original report on the prior year's financial statements.
- b. Continue to express a qualified opinion on the prior year's financial statements.
- c. Make **no** reference to the type of opinion expressed on the prior year's financial statements.
- d. Express an unmodified opinion on the restated financial statements of the prior year.

81. Before reporting on the financial statements of a US entity that have been prepared in conformity with another country's accounting principles, an auditor practicing in the US should

- a. Understand the accounting principles generally accepted in the other country.
- b. Be certified by the appropriate auditing or accountancy board of the other country.
- c. Notify management that the auditor is required to disclaim an opinion on the financial statements.
- d. Receive a waiver from the auditor's state board of accountancy to perform the engagement.

82. The financial statements of KCP America, a US entity, are prepared for inclusion in the consolidated financial statements

of its non-US parent. These financial statements are prepared in conformity with the accounting principles generally accepted in the parent's country and are for use only in that country. How may KCP America's auditor report on these financial statements?

- I. A US-style report (unmodified).
- II. A US-style report modified to report on the accounting principles of the parent's country.
- III. The report form of the parent's country.

	I	II	III
a.	Yes	No	No
b.	No	Yes	No
c.	Yes	No	Yes
d.	No	Yes	Yes

E.8. Summary of Placement of Additional Paragraphs

83. An auditor of a nonpublic company should disclose the substantive reasons for expressing an adverse opinion in a basis for modification paragraph

- a. Preceding the auditor's responsibility section
- b. Preceding the opinion section.
- c. Following the opinion section.
- d. Within the notes to the financial statements.

F.1. Audits of Financial Statements Prepared in Accordance with Special-Purpose Financial Reporting Frameworks

84. When an auditor reports on financial statements prepared on an entity's income tax basis, the auditor's report should

- a. Disclaim an opinion on whether the statements were examined in accordance with generally accepted auditing standards.
- b. Not express an opinion on whether the statements are presented in conformity with the financial reporting framework used.
- c. Include an explanation of how the results of operations differ from the cash receipts and disbursements basis of accounting.
- d. State that the basis of presentation is a financial reporting framework other than GAAP.

85. Helpful Co., a nonprofit entity, prepared its financial statements on an accounting basis prescribed by a regulatory agency solely for filing with that agency. Green audited the financial statements in accordance with generally accepted auditing standards and concluded that the financial statements were fairly presented on the prescribed basis. Green should issue a report with a(n)

- a. Qualified opinion.
- b. Adverse opinion
- c. Disclaimer of opinion.
- d. Unmodified opinion.

86. An auditor's report on financial statements prepared in conformity with the cash basis of accounting should include a separate emphasis-of-matter paragraph that

- a. Justifies the reasons for departing from generally accepted accounting principles.
- b. States whether the financial statements are fairly presented in conformity with GAAP.
- c. Refers to the note to the financial statements that describes the basis of accounting.
- d. Explains how the results of operations differ from financial statements prepared in conformity with generally accepted accounting principles.

87. An auditor's report would refer to a basis of accounting other than GAAP in which of the following situations?

- a. Interim financial information of a publicly held company that is subject to a limited review.
- b. Compliance with aspects of regulatory requirements related to audited financial statements.
- c. Application of accounting principles to specified transactions.
- d. Limited use prospective financial statements such as a financial projection.

88. Delta Life Insurance Co. prepares its financial statements on an accounting basis insurance companies use pursuant to the rules of a state insurance commission. If Wall, CPA, Delta's auditor, discovers that the statements are **not** suitably titled, Wall should

- a. Disclose any reservations in an emphasis-of-matter paragraph and qualify the opinion.
- b. Apply to the state insurance commission for an advisory opinion.
- c. Issue a special statutory basis report that clearly disclaims any opinion.
- d. Explain in the notes to the financial statements the terminology used.

89. Financial information is presented in a printed form that prescribes the wording of the independent auditor's report. The form is not acceptable to the auditor because the form calls for statements that are inconsistent with the auditor's responsibility. Under these circumstances, the auditor **most** likely would

- a. Withdraw from the engagement.
- b. Reword the form or attach a separate report.
- c. Express a qualified opinion with an explanation.
- d. Limit distribution of the report to the party who designed the form.

F.2. Audits of Single Financial Statements, and Specific Elements, Accounts, or Items of Financial Statements

90. Field is an employee of Gold Enterprises. Hardy, CPA, is asked to express an opinion on Field's profit participation in Gold's net income. Hardy may accept this engagement only if

- a. Hardy also audits Gold's complete financial statements.
- b. Gold's financial statements are prepared in conformity with GAAP.
- c. Hardy's report is available for distribution to Gold's other employees.
- d. Field owns controlling interest in Gold.

91. A CPA is permitted to accept a separate engagement (**not** in conjunction with an audit of financial statements) to audit an entity's

	Schedule of accounts receivable	Schedule of royalties
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

G.1.b. Reviewed Interim (Quarterly) Statements

92. In an accountant's review of interim financial information, the accountant typically performs each of the following, **except**

- a. Reading the available minutes of the latest stockholders' meeting.
- b. Applying financial ratios to the interim financial information.
- c. Inquiring of the accounting department's management.
- d. **Confirming major receivable accounts.**

93. When an independent CPA has reviewed the interim financial statements of a public client, which procedure is **least** likely to have been performed?

- a. Obtaining written representations from management for all interim financial information presented.
- b. **Observing the interim count of inventory.**
- c. Reading the financial statements for obvious material misstatements.
- d. Performing analytical procedures related to sales.

94. The objective of a review of interim financial information of a public entity (issuer) is to provide an accountant with a basis for reporting whether

- a. **Material modifications should be made to conform with generally accepted accounting principles.**
- b. A reasonable basis exists for expressing an updated opinion regarding the financial statements that were previously audited.
- c. Summary financial statements or pro forma financial information should be included in a registration statement.
- d. The financial statements are presented fairly in accordance with generally accepted accounting principles.

95. An independent accountant's report is based on a review of interim financial information. If this report is presented in a registration statement, a prospectus should include a statement clarifying that the

a. **Accountant's review report is not a part of the registration statement within the meaning of the Securities Act of 1933.**

- b. Accountant assumes **no** responsibility to update the report for events and circumstances occurring after the date of the report.
- c. Accountant's review was performed in accordance with standards established by the Securities and Exchange Commission.
- d. Accountant obtained corroborating evidence to determine whether material modifications are needed for such information to conform with GAAP.

96. A modification of the CPA's report on a review of the interim financial statements of a publicly held company would be necessitated by which of the following?

- a. An uncertainty.
- b. Lack of consistency.
- c. Reference to another accountant.
- d. **Inadequate disclosure.**

97. Which of the following procedures ordinarily should be applied when an independent accountant conducts a review of interim financial information of a publicly held entity?

- a. Verify changes in key account balances.
- b. **Read the minutes of the board of directors' meetings.**
- c. Inspect the open purchase order file.
- d. Perform cut-off tests for cash receipts and disbursements.

98. Which of the following is **least** likely to be a procedure included in an accountant's review of interim financial information of a public entity?

- a. Compare disaggregated revenue data by month to that of the previous interim period.
- b. Read available minutes of meetings of stockholders.
- c. **Observe counting of physical inventory.**
- d. Inquire of management concerning significant journal entries and other adjustments.

99. An accountant's review report on interim financial information of a public entity is **most** likely to include a

- a. Statement that the interim financial information was examined in accordance with standards of the Public Company Accounting Oversight Board.
- b. Statement that the interim financial information is the responsibility of the entity's shareholders.
- c. **Description of the procedures for a review.**
- d. Statement that a review of interim financial information is less in scope than a compilation conducted in accordance with AICPA standards.

G.1.c. Summary Financial Statements

100. An auditor may report on summary financial statements that are derived from complete financial statements if the

- a. Summary financial statements are distributed to stockholders along with the complete financial statements.

- b. Auditor described the additional procedures performed on the summary financial statements.
- c. Auditor indicates whether the information in the summary financial statements is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.
- d. Summary financial statements are presented in comparative form with the prior year's summary financial statements.

101. An auditor is engaged to report on selected financial data that are included in a document containing audited financial statements. Under these circumstances, the report on the selected data should

- a. Be limited to data derived from the audited financial statements.
- b. Be distributed only to senior management and the board of directors.
- c. State that the presentation is a financial reporting framework other than GAAP.
- d. Indicate that the data are not fairly stated in all material respects.

G.2.a. Letters for Underwriters

102. A registration statement filed with the SEC contains the reports of two independent auditors on their audits of financial statements for different periods. The predecessor auditor who audited the prior period financial statements generally should obtain a letter of representation from the

- a. Successor independent auditor.
- b. Client's audit committee.
- c. Principal underwriter.
- d. Securities and Exchange Commission.

103. Which of the following statements is correct concerning letters for underwriters, commonly referred to as comfort letters?

- a. Letters for underwriters are required by the Securities Act of 1933 for the initial public sale of registered securities.
- b. Letters for underwriters typically give negative assurance on unaudited interim financial information.
- c. Letters for underwriters usually are included in the registration statement accompanying a prospectus.
- d. Letters for underwriters ordinarily update auditors' opinions on the prior year's financial statements.

104. Comfort letters ordinarily are signed by the client's

- a. Independent auditor.
- b. Underwriter of securities.
- c. Audit committee.
- d. Senior management.

105. Comfort letters ordinarily are addressed to

- a. Creditor financial institutions.
- b. The client's audit committee.
- c. The Securities and Exchange Commission.
- d. Underwriters of securities.

106. When an accountant issues to an underwriter a comfort letter containing comments on data that have **not** been audited, the underwriter **most** likely will receive

- a. Negative assurance on capsule information.
- b. Positive assurance on supplementary disclosures.
- c. A limited opinion on pro forma financial statements.
- d. A disclaimer on prospective financial statements.

107. When an independent audit report is incorporated by reference in a SEC registration statement, a prospectus that includes a statement about the independent accountant's involvement should refer to the independent accountant as

- a. Auditor of the financial reports.
- b. Management's designate before the SEC.
- c. Certified preparer of the report.
- d. Expert in auditing and accounting.

108. Which of the following matters is covered in a typical comfort letter?

- a. Negative assurance concerning whether the entity's internal control procedures operated as designed during the period being audited.
- b. An opinion regarding whether the entity complied with laws and regulations under Government Auditing Standards and the Single Audit Act of 1984.
- c. Positive assurance concerning whether unaudited condensed financial information complied with generally accepted accounting principles.
- d. An opinion as to whether the audited financial statements comply in form with the accounting requirements of the SEC.

109. When unaudited financial statements are presented in comparative form with audited financial statements in a document filed with the Securities and Exchange Commission, such statements should be

	Marked as "unaudited"	Withheld until audited	Referred to in the auditor's report
a.	Yes	No	No
b.	Yes	No	Yes
c.	No	Yes	Yes
d.	No	Yes	No

110. In connection with a proposal to obtain a new audit client, a CPA in public practice is asked to prepare a report on the application of accounting principles to a specific transaction. The CPA's report should include a statement that

- a. The engagement was performed in accordance with Statements on Standards for Accounting and Review Services.
- b. Responsibility for the proper accounting treatment rests with the preparers of the financial statements.
- c. The evaluation of the application of accounting principles is hypothetical and may **not** be used for opinion-shopping.
- d. The guidance is provided for management's use only and may not be communicated to the prior or continuing auditor.

G.2.b. Application of Requirements of an Applicable Financial Reporting Framework

111. In connection with a proposal to obtain a new client, an accountant in public practice is asked to prepare a written report on the application of accounting principles to a specific transaction. The accountant's report should include a statement that

- a. Any difference in the facts, circumstances, or assumptions presented may change the report.
- b. The engagement was performed in accordance with Statements on Standards for Consulting Services.
- c. The guidance provided is for management use only and may **not** be communicated to the prior or continuing auditors.
- d. Nothing came to the accountant's attention that caused the accountant to believe that the accounting principles violated GAAP.

112. Blue, CPA, has been asked to render an opinion on the application of accounting principles to a specific transaction by an entity that is audited by another CPA. Blue, who previously has provided no services to the entity, may accept this engagement, but should

- a. Consult with the continuing CPA to obtain information relevant to the transaction.
- b. Report the engagement's findings to the entity's audit committee, the continuing CPA, and management.
- c. Disclaim any opinion that the hypothetical application of accounting principles conforms with generally accepted accounting principles.
- d. Notify the entity that the report is for the restricted use of management and outside parties who are aware of all relevant facts.

113. Which of the following statements is **not** included in an accountant's report on the application of accounting principles?

- a. The engagement was performed following standards established by the American Institute of Certified Public Accountants.
- b. The report is based on a hypothetical transaction not involving facts or circumstances of this particular entity.
- c. The report is intended solely for the information and use of specified parties.
- d. Responsibility for the proper accounting treatment rests with the preparers of the financial statements.

G.3.a. Attestation Engagements—General

114. Which of the following services would be **most** likely to be structured as an attest engagement in which assurance is provided?

- a. Advocating a client's position in tax matter.
- b. A consulting engagement to develop a new database system for the revenue cycle.
- c. An engagement to issue a report addressing an entity's compliance with requirements of specified laws.
- d. The compilation of a client's forecast information.

115. An unmodified attestation report ordinarily may refer to

- a. Only the assertion.
- b. Only the subject matter to which the assertion relates.
- c. Either the assertion or the subject matter to which the assertion relates.
- d. Neither the assertion nor the subject matter to which the assertion relates.

116. A practitioner is issuing a standard unmodified examination report under the attestation standards. The CPA's conclusion may be on

	Subject matter	Management's written assertion
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

117. Conditions exist that result in a material deviation from the criteria against which the subject matter was evaluated during an examination. The CPA's conclusion may be on

	Subject matter	Written assertion
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

118. When performing an attestation engagement, which of the following is **least** likely to be present?

- a. Practitioner's written assertion.
- b. Responsible party.
- c. Subject matter.
- d. Suitable criteria.

119. Suitable criteria in an attestation engagement may be available

	Publicly	In CPA's report
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

120. Which of the following is **least** likely to be included in an agreed-upon procedures attestation engagement report?

- a. The specified party takes responsibility for the sufficiency of procedures.
- b. Use of the report is restricted.
- c. Limited assurance on the information presented.
- d. A summary of procedures performed.

121. A summary of findings rather than assurance is **most** likely to be included in

- a. Agreed-upon procedures report.
- b. Compilation report.
- c. Examination report.
- d. Review report.

G.3.b. Agreed-Upon Procedures Engagements

122. Which of the following is **not** correct concerning “specified parties” of an agreed-upon procedures report under either the auditing or attestation standards?

- a. They must agree on the procedures to be performed.
- b. They must take responsibility for the adequacy of the procedures performed.
- c. They must sign an engagement letter.
- d. After completion of the engagement, another party may be added as a specified user.

G.3.c. Financial Forecasts and Projections

123. When an accountant examines projected financial statements, the accountant’s report should include a separate paragraph that

- a. Describes the limitations on the usefulness of the presentation.
- b. Provides an explanation of the differences between an examination and an audit.
- c. States that the accountant is responsible for events and circumstances up to one year after the report’s date.
- d. Disclaims an opinion on whether the assumptions provide a reasonable basis for the projection.

124. An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that

- a. Use of the report is restricted to the specified parties.
- b. The prospective financial statements are also examined.
- c. Responsibility for the adequacy of the procedures performed is taken by the accountant.
- d. Negative assurance is expressed on the prospective financial statements taken as a whole.

125. An accountant’s compilation report on a financial forecast should include a statement that

- a. The forecast should be read only in conjunction with the audited historical financial statements.
- b. The accountant expresses only limited assurance on the forecasted statements and their assumptions.
- c. There will usually be differences between the forecasted and actual results.
- d. The hypothetical assumptions used in the forecast are reasonable in the circumstances.

126. Accepting an engagement to examine an entity’s financial projection **most** likely would be appropriate if the projection were to be distributed to

- a. All employees who work for the entity.
- b. Potential stockholders who request a prospectus or a registration statement.
- c. A bank with which the entity is negotiating for a loan.
- d. All stockholders of record as of the report date.

127. A CPA in public practice is required to comply with the provisions of the Statements on Standards for Attestation Engagements (SSAE) when

	Testifying as an expert witness in accounting and auditing matters given stipulated facts	Compiling a client’s financial projection that presents a hypothetical course of action
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

128. An accountant’s compilation report on a financial forecast should include a statement that the

- a. Compilation does not include evaluation of the support of the assumptions underlying the forecast.
- b. Hypothetical assumptions used in the forecast are reasonable.
- c. Range of assumptions selected is one in which one end of the range is less likely to occur than the other.
- d. Prospective statements are limited to presenting, in the form of a forecast, information that is the accountant’s representation.

129. Which of the following is a prospective financial statement for general use upon which an accountant may appropriately report?

- a. Financial projection.
- b. Partial presentation.
- c. Pro forma financial statement.
- d. Financial forecast.

130. Which of the following is **not** included in a compilation report on prospective financial statements?

- a. A statement that the practitioner assumes no responsibility to update the report for events and circumstances occurring after the date of the report.
- b. A caveat that the prospective results may not be achieved.
- c. A statement that a compilation is limited in scope and does not enable the practitioner to express an opinion or any other form of assurance on the information.
- d. Distribution of the report is restricted to specified parties.

131. When an accountant examines a financial forecast that fails to disclose several significant assumptions used to prepare the forecast, the accountant should describe the assumptions in the accountant’s report and issue a(n)

- a. “Except for” qualified opinion.
- b. “Subject to” qualified opinion.
- c. Unmodified opinion with a separate emphasis-of-matter paragraph.
- d. Adverse opinion.

132. An examination of a financial forecast is a professional service that involves

- a. Compiling or assembling a financial forecast that is based on management's assumptions.
- b. Limiting the distribution of the accountant's report to management and the board of directors.
- c. Assuming responsibility to update management on key events for one year after the report's date.
- d. Evaluating the preparation of a financial forecast and the support underlying management's assumptions.**

G.3.d. Reporting on Pro Forma Financial Information

133. Given one or more hypothetical assumptions, a responsible party may prepare, to the best of its knowledge and belief, an entity's expected financial position, results of operations, and changes in financial position. Such prospective financial statements are known as

- a. Pro forma financial statements.
- b. Financial projections.**
- c. Partial presentations.
- d. Financial forecasts.

134. An accountant's report on a review of pro forma financial information should include a

- a. Statement that the entity's internal control was not relied on in the review.
- b. Disclaimer of opinion on the financial statements from which the pro forma financial information is derived.
- c. Caveat that it is uncertain whether the transaction or event reflected in the pro forma financial information will ever occur.
- d. Reference to the financial statements from which the historical financial information is derived.**

G.3.e. Management Discussion and Analysis

135. Which of the following is **not** an objective of a CPA's examination of a client's management discussion and analysis (MD&A) prepared pursuant to Securities and Exchange Commission rules and regulations?

- a. The historical amounts have been accurately derived, in all material respects, from the entity's financial statements.
- b. The presentation is in conformity with rules and regulations adopted by the Securities and Exchange Commission.**
- c. The underlying information, determinations, estimates and assumptions of the entity provide a reasonable basis for the disclosures contained herein.
- d. The presentation includes the required elements of MD&A.

136. Which of the following is an assertion embodied in management's discussion and analysis (MD&A)?

- a. Valuation.
- b. Reliability.

c. Consistency with the financial statements.

d. Rights and obligations.

137. Which of the following statements is correct relating to an auditor's review engagements on an entity's management discussion and analysis (MD&A)?

- a. A review consists principally of applying analytical procedures and search and verification procedures.
- b. The review report of a public entity should be restricted to the use of specified parties.**
- c. No consideration of internal control is necessary.
- d. The report issued will ordinarily include a summary of findings, but no negative assurance.

G.3.f. Trust Services

138. Trust Service engagements are performed under the provisions of

- a. Statements on Assurance Standards.
- b. Statements on Standards for Attestation Engagements.**
- c. Statements on Standards for Trust Engagements
- d. Statements on Auditing Standards.

139. The WebTrust seal of assurance relates most directly to

- a. Financial statements maintained on the Internet.
- b. Health care facilities.
- c. Risk assurance procedures.
- d. Websites.**

140. A CPA's examination report relating to a WebTrust engagement is **most** likely to include

- a. An opinion on whether the site is "hackproof."
- b. An opinion on whether the site meets the WebTrust criteria.**
- c. Negative assurance on whether the site is electronically secure.
- d. No opinion or other assurance, but a summary of findings relating to the website.

141. An engagement in which a CPA considers security, availability, processing integrity, online privacy, and/or confidentiality over any type of defined electronic system is **most** likely to be considered which of the following types of engagements?

- a. Internal control over financial reporting.
- b. SysTrust.**
- c. Website Associate.
- d. WebTrust.

142. A client's refusal to provide a written assertion in a Trust Services engagement is **most** likely to result in which of the following types of opinions?

- a. Adverse.
- b. Disclaimer.**
- c. Qualified.
- d. Unmodified with explanatory language.

G.3.g. Service Organizations

143. Dunn, CPA, is auditing the financial statements of Taft Co. Taft uses Quick Service Center (QSC) to process its

payroll. Price, CPA, is expressing an opinion on a description of the controls implemented at QSC regarding the processing of its customers' payroll transactions. Dunn expects to consider the effects of Price's report on the Taft engagement. Price's report should contain a(n)

- Description of the scope and nature of Price's procedures.
- Statement that Dunn may assess control risk based on Price's report.
- Assertion that Price assumes no responsibility to determine whether QSC's controls are suitably designed.
- Opinion on the operating effectiveness of QSC's internal controls.

144. Payroll Data Co. (PDC) processes payroll transactions for a retailer. Cook, CPA, is engaged to express an opinion on a description of PDC's internal controls implemented as of a specific date. These controls are relevant to the retailer's internal control, so Cook's report may be useful in providing the retailer's independent auditor with information necessary to plan a financial statement audit. Cook's report should

- Contain a disclaimer of opinion on the operating effectiveness of PDC's controls.
- State whether PDC's controls were suitably designed to achieve the retailer's objectives.
- Identify PDC's controls relevant to specific financial statement assertions.
- Disclose Cook's assessed level of control risk for PDC.

145. The auditor who audits the processing of transactions by a service organization may issue a report on controls

	Implemented	Operating effectiveness
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

146. Computer Services Company (CSC) processes payroll transactions for schools. Drake, CPA, is engaged to report on CSC's policies and procedures implemented as of a specific date. These policies and procedures are relevant to the schools' internal control, so Drake's report will be useful in providing the schools' independent auditors with information necessary to plan their audits. Drake's report expressing an opinion on CSC's policies and procedures implemented as of a specific date should contain a(n)

- Description of the scope and nature of Drake's procedures.
- Statement that CSC's management has disclosed to Drake all design deficiencies of which it is aware.
- Opinion on the operating effectiveness of CSC's policies and procedures.
- Paragraph indicating the basis for Drake's assessment of control risk.

147. Lake, CPA, is auditing the financial statements of Gill Co. Gill uses the EDP Service Center, Inc. to process its payroll transactions. EDP's financial statements are audited by Cope, CPA, who recently issued a report on EDP's internal

control. Lake is considering Cope's report on EDP's internal control in assessing control risk on the Gill engagement. What is Lake's responsibility concerning making reference to Cope as a basis, in part, for Lake's own opinion?

- Lake may refer to Cope only if Lake is satisfied as to Cope's professional reputation and independence.
- Lake may refer to Cope only if Lake relies on Cope's report in restricting the extent of substantive tests.
- Lake may refer to Cope only if Lake's report indicates the division of responsibility.
- Lake may **not** refer to Cope under the circumstances above.

148. Which of the following is correct relating to service organization control (SOC) reports referred to as "SOC 2" reports?

- They are primarily to assist financial statement auditors when processing services have been outsourced to a service provider.
- They are generally available to anyone.
- They relate most directly to internal control over financial reporting.
- They are meant for management of service organizations, user entities and certain other specified entities.

149. The type of service organization control (SOC) report that is for general use is

- SOC 1.
- SOC 2.
- SOC 3.**
- SOC 4.

150. The AICPA has outlined auditor reports based on three services that may be provided on service organization controls (SOC). The type **most** likely to result in a restricted use report on controls at a service organization related to security, availability, processing integrity, confidentiality, and/or privacy is

- SOC 2.**
- SOC SYS.
- SOC 6.
- SOC OC.

H. Audits (Examinations) of Internal Control

151. The internal control provisions of the Sarbanes-Oxley Act of 2002 apply to which companies in the United States?

- All companies.
- SEC registrants.**
- All issuer (public) companies and nonissuer (nonpublic) companies with more than \$100,000,000 of net worth.
- All nonissuer companies.

152. The framework **most** likely to be used by management in its internal control assessment under requirements of the Sarbanes-Oxley Act of 2002 is the

- COSO internal framework.**
- COSO enterprise risk management framework.
- FASB 37 internal control definitional framework.
- AICPA internal control analysis manager.

153. Which of the following **best** describes a CPA's engagement to report on an entity's internal control over financial reporting?

- a. An engagement to form an opinion on the effectiveness of its internal control.
- b. An audit engagement to provide negative assurance on the entity's internal control.
- c. A prospective engagement to project, for a period of time **not** to exceed one year, and report on the expected benefits of the entity's internal control.
- d. A consulting engagement to provide constructive advice to the entity on its internal control.

154. An engagement to examine internal control will generally

- a. Require procedures that duplicate those already applied in assessing control risk during a financial statement audit.
- b. Increase the reliability of the financial statements that have already been audited.
- c. Be more extensive in scope than the assessment of control risk made during a financial statement audit.
- d. Be more limited in scope than the assessment of control risk made during a financial statement audit.

155. Which of the following is correct concerning the level of assistance auditors may provide in assisting management with its assessment of internal control?

- a. No assistance of any type may be provided.
- b. No limitations on assistance exist.
- c. Only very limited assistance may be provided.
- d. As less risk is assumed by the auditors, a higher level of assistance is appropriate.

156. Which of the following need **not** be included in management's report on internal control under Section 404a of the Sarbanes-Oxley Act of 2002?

- a. A statement that the company's auditor has issued an attestation report on management's assertion.
- b. Identification of the framework for evaluating internal control.
- c. Management's assessment of the effectiveness of internal control.
- d. Management's statement of responsibility to establish and maintain internal control that has no significant deficiencies.

157. Which of the following is an accurate statement about internal control weaknesses?

- a. Material weaknesses are also control deficiencies.
- b. Significant deficiencies are also material weaknesses.
- c. Control deficiencies are also material weaknesses.
- d. All control deficiencies must be communicated to the audit committee.

158. In an integrated audit, which of the following is defined as a weakness in internal control that is less severe than a material weakness but important enough to warrant attention by those responsible for oversight of the financial reporting function?

- a. Control deficiency.
- b. Unusual weakness.
- c. Unusual deficiency.
- d. Significant deficiency.

159. A material weakness is a significant deficiency (or combination of significant deficiencies) that results in a reasonable possibility that a misstatement of at least what amount will **not** be prevented or detected?

- a. An amount greater than zero.
- b. An amount greater than zero, but at least inconsequential.
- c. An amount greater than inconsequential.
- d. A material amount.

160. The minimum likelihood of loss involved in the consideration of a control deficiency is

- a. Remote.
- b. More than remote.
- c. Probable.
- d. Not explicitly considered.

161. Assume that a company has a control deficiency regarding the processing of cash receipts. Reconciliation of cash accounts by a competent individual otherwise independent of the cash function might make the likelihood of a significant misstatement due to the control deficiency remote. In this situation, reconciliation may be referred to as what type of control?

- a. Compensating.
- b. Preventive.
- c. Adjustive.
- d. Nonroutine.

162. According to Public Company Accounting Oversight Board auditing standards, what type of transaction involves establishing a loan loss reserve?

- a. Substantive transaction.
- b. Routine transaction.
- c. Nonroutine transaction.
- d. Estimation transaction.

163. How do the scope, procedures, and purpose of an examination of internal control compare to those for obtaining an understanding of internal control and assessing control risk as part of an audit?

	Scope	Procedures	Purpose
a.	Similar	Different	Similar
b.	Different	Similar	Similar
c.	Different	Different	Different
d.	Different	Similar	Different

164. A procedure that involves tracing a transaction from its origination through the company's information systems until it is reflected in the company's financial report is referred to as a(n)

- a. Analytical analysis.
- b. Substantive procedure.
- c. Test of a control.

d. Walk-through.

165. For purposes of an audit of internal control performed under Public Company Accounting Oversight Board standards, the “as of date” is ordinarily

- a. The first day of the year.
- b. The last day of the fiscal period.
- c. The last day of the auditor’s fieldwork.
- d. The average date for the entire fiscal period.

166. Consider an issuer (public) company whose purchases are made through the Internet and by telephone. Which of the following is correct?

- a. These types of purchases represent control objectives for the audit of internal control.
- b. These purchases are the assertions related to the purchase class of transactions.
- c. These types of purchases represent two major classes of transactions within the purchases process.
- d. These two types of transactions represent routine transactions that must always be investigated in extreme detail.

167. For an issuer (public) company audit of internal control, walkthroughs provide the auditor with *primary evidence* to

	Evaluate the effectiveness of the design of controls	Confirm whether controls have been implemented
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

168. Which is **most** likely to be a question asked of employee personnel during a walk-through in an audit of the internal control of an issuer (public) company?

- a. Have you ever been asked to override the process?
- b. Do you believe that you are underpaid?
- c. What do you do when you find a fraudulent transaction?
- d. Who trained you for this job?

169. How large must the *actual loss identified by the auditor* be for a control deficiency to possibly be considered a material weakness?

	Immaterial	Material
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

170. For purposes of an audit of internal control performed under Public Company Accounting Oversight Board requirements, an account is significant if there is more than a

- a. Reasonably possible likelihood that it could contain immaterial or material misstatements.
- b. Reasonably possible likelihood that it could contain material misstatements.
- c. Remote likelihood that it could contain material misstatements.

- d. Remote likelihood that it could contain more than inconsequential misstatements.

171. A control deficiency that is more than a significant deficiency is **most** likely to result in what form of audit opinion relating to internal control?

- a. Adverse.
- b. Qualified.
- c. Unqualified.
- d. Unqualified with explanatory language.

172. Which of the following is **most** likely to be considered a material weakness in internal control for purposes of an internal control audit of an issuer (public) company?

- a. An ineffective oversight of financial reporting by the audit committee.
- b. Restatement of previously issued financial statements due to a change in accounting principles.
- c. Inadequate segregation of recordkeeping from accounting.
- d. Weaknesses in control activities.

173. Inability to evaluate internal control due to a circumstance-caused scope limitation relating to a significant account in a Sarbanes-Oxley 404 internal control audit is **most** likely to result in a(n)

- a. Adverse opinion.
- b. Qualified opinion.
- c. Unqualified opinion with explanatory language.
- d. All of the above are equally likely.

174. Which of the following is **most** likely to indicate a significant deficiency relating to a client’s antifraud programs?

- a. A broad scope of internal audit activities.
- b. A “whistle-blower” program that encourages anonymous submissions.
- c. Audit committee passivity when conducting oversight functions.
- d. Lack of performance of criminal background investigations for likely customers.

175. An auditor identified a material weakness in December. The client was informed and corrected it shortly after the “as of date” (December 31); the auditor agrees that the correction eliminates the material weakness as of January 31. The appropriate report under a PCAOB audit of internal control is

- a. Adverse.
- b. Unqualified.
- c. Unqualified with explanatory language relating to the material weakness.
- d. Qualified.

176. In an integrated audit, which of the following lead(s) to an adverse opinion on internal control?

	Material weaknesses	Significant deficiencies
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

177. In an integrated audit, what must the auditor communicate to the audit committee?

	Known material weaknesses	All control deficiencies
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

178. In which manner are significant deficiencies communicated by the auditors to the audit committee under Public Company Accounting Oversight Board requirements?

- a. The communication may either be orally or in written form.
- b. The communication must be oral, and not in written form.
- c. The communication must be in written form.**
- d. No such communication is required as only material weaknesses must be communicated.

179. Which is correct concerning the external auditors' use of the work of others in an audit of internal control performed for a public company?

- a. It is not allowed.
- b. The work of internal auditors may be used, but only when those internal auditors report directly to the audit committee.
- c. Ordinarily the work of internal auditors and others is used primarily in low-risk areas.**
- d. There is no limitation and is likely to reduce auditor liability since the auditors will then share legal responsibility with those who have performed the service.

180. In an integrated audit, which must the auditor communicate in writing to management?

- a. Only material weaknesses.
- b. Material weaknesses and significant deficiencies.
- c. Material weaknesses, significant deficiencies and other control deficiencies.**
- d. Material weaknesses, significant deficiencies, other control deficiencies, and all suspected and possible employee law violations.

181. Which of the following is correct when applying a top-down approach to identify controls to test in an integrated audit?

- a. For certain assertions, strong entity-level controls may allow the auditor to omit additional testing beyond those controls.**
- b. Starting at the top—controls over specific assertions—the auditor should link to major accounts and reporting items.
- c. The goal is to focus on details of accounting controls, while avoiding consideration of overall entity-level controls.
- d. The goal is to focus on all controls related to assertions, omitting consideration of controls related to the financial statements.

182. Which of the following is **not** included in a standard unqualified opinion on internal control over financial reporting performed under PCAOB requirements?

- a. Because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements.
- b. In our opinion, [company name] maintained, in all material respects, effective internal control over financial reporting.
- c. Our audit included obtaining an understanding of internal control over financial reporting.
- d. The [company name] management and audit committee is responsible for maintaining effective internal control over financial reporting.**

183. In reporting on an entity's internal control over financial reporting, a practitioner should include a paragraph that describes the

- a. Documentary evidence regarding the control environment factors.
- b. Changes in internal control since the prior report.
- c. Potential benefits from the practitioner's suggested improvements.
- d. Inherent limitations of any internal control.**

184. When an independent auditor reports on internal control based on criteria established by governmental agencies, the report should

- a. Not include the agency's name in the report.
- b. Indicate matters covered by the study and whether the auditor's study included tests of controls with the procedures covered by the study.**
- c. Not express a conclusion based on the agency's criteria.
- d. Assume responsibility for the comprehensiveness of the criteria established by the agency and include recommendations for corrective action.

185. When an examination has been performed on the effectiveness of entity's internal control over financial reporting and a material weakness has been noted, the practitioner's report should express an opinion on

- a. The assertion.
- b. The subject matter to which the assertion relates.**
- c. Neither of the above.
- d. Both of the above.

I.2.a. Agreed-Upon Procedures Engagements

186. Which of the following types of engagements is **not** permitted under the professional standards for reporting on an entity's compliance?

- a. Agreed-upon procedures on compliance with the specified requirements of a law.
- b. Agreed-upon procedures on the effectiveness of internal control over compliance with a law.
- c. Review on compliance with specified requirements of a law.**
- d. Examination on compliance with specified requirements of a law.

187. Mill, CPA, was engaged by a group of royalty recipients to apply agreed-upon procedures to financial data supplied by Modern Co. regarding Modern's written assertion about its compliance with contractual requirements to pay

royalties. Mill's report on these agreed-upon procedures should contain a(n)

- a. Disclaimer of opinion about the fair presentation of Modern's financial statements.
- b. List of the procedures performed (or reference thereto) and Mill's findings.**
- c. Opinion about the effectiveness of Modern's internal control activities concerning royalty payments.
- d. Acknowledgment that the sufficiency of the procedures is solely Mill's responsibility.

188. A CPA's report on agreed-upon procedures related to an entity's compliance with specified requirements should contain

- a. A statement of limitations on the use of the report.**
- b. An opinion about whether management's assertion is fairly stated.
- c. Negative assurance that control risk has not been assessed.
- d. An acknowledgment of responsibility for the sufficiency of the procedures.

1.2.b. Examination Engagements

189. When reporting on an examination of a company's compliance with requirements of specified laws, the practitioner has identified an instance of material noncompliance. Management has agreed to include this instance in its written assertion. The examination report should include

- a. No modification from the standard form.
- b. An opinion paragraph that is unmodified, and an emphasis-of-matter paragraph.
- c. A qualified or adverse opinion.**
- d. A disclaimer of opinion.

1.3.a. Compliance Audits Conducted in Accordance with GAAS

190. In auditing a not-for-profit entity that receives governmental financial assistance, the auditor has a responsibility to

- a. Issue a separate report that describes the expected benefits and related costs of the auditor's suggested changes to the entity's internal control.
- b. Assess whether management has identified laws and regulations that have a direct and material effect on the entity's financial statements.**
- c. Notify the governmental agency providing the financial assistance that the audit is **not** designed to provide any assurance of detecting misstatements and fraud.
- d. Render an opinion concerning the entity's continued eligibility for the governmental financial assistance.

191. Hill, CPA, is auditing the financial statements of Helping Hand, a not-for-profit organization that receives financial assistance from governmental agencies. To detect misstatements in Helping Hand's financial statements resulting from violations of laws and regulations, Hill should focus on violations that

- a. Could result in criminal prosecution against the organization.
- b. Involve significant deficiencies to be communicated to the organization's trustees and the funding agencies.
- c. Have a direct and material effect on the amounts in the organization's financial statements.**
- d. Demonstrate the existence of material weaknesses.

192. A governmental audit may extend beyond an examination leading to the expression of an opinion on the fairness of financial presentation to include

	Program results	Compliance	Economy and efficiency
a.	Yes	Yes	No
b.	Yes	Yes	Yes
c.	No	Yes	Yes
d.	Yes	No	Yes

193. When auditing an entity's financial statements in accordance with Government Auditing Standards (the "Yellow Book"), an auditor is required to report on

- I. Noteworthy accomplishments of the program.
- II. The scope of the auditor's testing of internal controls.
- a. I only.
- b. II only.**
- c. Both I and II.
- d. Neither I nor II.

194. When auditing an entity's financial statements in accordance with Government Auditing Standards (the "Yellow Book"), an auditor is required to report on

- I. Recommendations for actions to improve operations.
- II. The scope of the auditor's tests of compliance with laws and regulations.
- a. I only.
- b. II only.**
- c. Both I and II.
- d. Neither I nor II.

1.3.b. Compliance Audits Conducted in Accordance with Generally Accepted Government Auditing Standards (GAGAS)

195. Which of the following statements is a standard applicable to financial statement audits in accordance with Government Auditing Standards (the "Yellow Book")?

- a. An auditor should report on the scope of the auditor's testing of compliance with laws and regulations.**
- b. An auditor should assess whether the entity has reportable measures of economy and efficiency that are valid and reliable.
- c. An auditor should report recommendations for actions to correct problems and improve operations.
- d. An auditor should determine the extent to which the entity's programs achieve the desired results.

196. Which of the following statements is a standard applicable to financial statement audits in accordance with Government Auditing Standards (the “Yellow Book”)?

- a. An auditor should report on the scope of the auditor’s testing of internal controls.
- b. All instances of abuse, waste, and mismanagement should be reported to the audit committee.
- c. An auditor should report the views of responsible officials concerning the auditor’s findings.
- d. Internal control activities designed to detect or prevent fraud should be reported to the inspector general.

197. In reporting under Government Auditing Standards, an auditor **most** likely would be required to report a falsification of accounting records directly to a federal inspector general when the falsification is

- a. Discovered after the auditor’s report has been made available to the federal inspector general and to the public.
- b. Reported by the auditor to the audit committee as a significant deficiency in internal control.
- c. Voluntarily disclosed to the auditor by low-level personnel as a result of the auditor’s inquiries.
- d. Communicated by the auditor to the auditee and the auditee fails to make a required report of the matter.

198. Although the scope of audits of recipients of federal financial assistance in accordance with federal audit regulations varies, these audits generally have which of the following elements in common?

- a. The auditor is to determine whether the federal financial assistance has been administered in accordance with applicable laws and regulations.
- b. The materiality levels are lower and are determined by the government entities that provided the federal financial assistance to the recipient.
- c. The auditor should obtain written management representations that the recipient’s internal auditors will report their findings objectively without fear of political repercussion.
- d. The auditor is required to express both positive and negative assurance that illegal acts that could have a material effect on the recipient’s financial statements are disclosed to the inspector general.

199. An auditor **most** likely would be responsible for communicating significant deficiencies in the design of internal control

- a. To the Securities and Exchange Commission when the client is a publicly held entity.
- b. To specific legislative and regulatory bodies when reporting under Government Auditing Standards.
- c. To a court-appointed creditors’ committee when the client is operating under Chapter 11 of the Federal Bankruptcy Code.
- d. To shareholders with significant influence (more than 20% equity ownership) when significant deficiencies are deemed to be material weaknesses.

200. Wolf is auditing an entity’s compliance with requirements governing a major federal financial assistance program in accordance with Government Auditing Standards. Wolf detected noncompliance with requirements that have a material effect on the program. Wolf’s report on compliance should express

- a. No assurance on the compliance tests.
- b. Reasonable assurance on the compliance tests.
- c. A qualified or adverse opinion.
- d. An adverse or disclaimer of opinion.

201. Which of the following is a specific documentation requirement that an auditor should follow when auditing in accordance with Government Auditing Standards?

- a. The auditor should obtain written representations from management acknowledging responsibility for correcting instances of fraud, abuse, and waste.
- b. Before the report is issued, evidence of supervisory review of the audit.
- c. The auditor should document the procedures that assure discovery of all illegal acts and contingent liabilities resulting from noncompliance.
- d. The auditor’s working papers should contain a caveat that all instances of material misstatements and fraud may not be identified.

202. In performing a financial statement audit in accordance with Government Auditing Standards, an auditor is required to report on the entity’s compliance with laws and regulations. This report should

- a. State that compliance with laws and regulations is the responsibility of the entity’s management.
- b. Describe the laws and regulations that the entity must comply with.
- c. Provide an opinion on overall compliance with laws and regulations.
- d. Indicate that the auditor does not possess legal skills and cannot make legal judgments.

203. In reporting under Government Auditing Standards, an auditor **most** likely would be required to communicate management’s misappropriation of assets directly to a federal inspector general when the fraudulent activities are

- a. Concealed by management by circumventing specific internal controls designed to safeguard those assets.
- b. Reported to the entity’s governing body and the governing body fails to make a required report to the federal inspector general.
- c. Accompanied by fraudulent financial reporting that results in material misstatements of asset balances.
- d. Perpetrated by several levels of management in a scheme that is likely to continue in future years.

1.3.c. Compliance Audits Conducted in Accordance with the Single Audit Act

204. In auditing compliance with requirements governing major federal financial assistance programs under the Single Audit Act, the auditor’s consideration of materiality differs from materiality under generally accepted auditing standards. Under the Single Audit Act, materiality is

- a. Calculated in relation to the financial statements taken as a whole.
- b. Determined separately for each major federal financial assistance program.
- c. Decided in conjunction with the auditor's risk assessment.
- d. Ignored, because all account balances, regardless of size, are fully tested.

205. Kent is auditing an entity's compliance with requirements governing a major federal financial assistance program in accordance with the Single Audit Act. Kent detected noncompliance with requirements that have a material effect on that program. Kent's report on compliance should express a(n)

- a. Unmodified opinion with a separate emphasis-of-matter paragraph.
- b. Qualified opinion or an adverse opinion.
- c. Adverse opinion or a disclaimer of opinion.
- d. Limited assurance on the items tested.

206. When performing an audit of a city that is subject to the requirements of the Uniform Single Audit Act of 1984, an auditor should adhere to

- a. Governmental Accounting Standards Board General Standards.
- b. Governmental Finance Officers Association Governmental Accounting, Auditing, and Financial Reporting Principles.

- c. General Accounting Office Government Auditing Standards.
- d. Securities and Exchange Commission Regulation S-X.

207. A CPA has performed an examination of the general-purpose financial statements of Big City. The examination scope included the additional requirements of the Single Audit Act. When reporting on Big City's internal accounting and administrative controls used in administering a federal financial assistance program, the CPA should

- a. Communicate those weaknesses that are material in relation to the general-purpose financial statements.
- b. Express an opinion on the systems used to administer major federal financial assistance programs and express negative assurance on the systems used to administer nonmajor federal financial assistance programs.
- c. Communicate those weaknesses that are material in relation to the federal financial assistance program.
- d. Express negative assurance on the systems used to administer major federal financial assistance programs and express no opinion on the systems used to administer nonmajor federal financial assistance programs.

Multiple-Choice Answers and Explanations

Answers

1. a	—	—	45. b	—	—	89. b	—	—	133. b	—	—	177. b	—	—
2. b	—	—	46. a	—	—	90. a	—	—	134. d	—	—	178. c	—	—
3. a	—	—	47. d	—	—	91. a	—	—	135. b	—	—	179. c	—	—
4. c	—	—	48. a	—	—	92. d	—	—	136. c	—	—	180. c	—	—
5. c	—	—	49. b	—	—	93. b	—	—	137. b	—	—	181. a	—	—
6. b	—	—	50. c	—	—	94. a	—	—	138. b	—	—	182. d	—	—
7. d	—	—	51. c	—	—	95. a	—	—	139. d	—	—	183. d	—	—
8. a	—	—	52. d	—	—	96. d	—	—	140. b	—	—	184. b	—	—
9. a	—	—	53. c	—	—	97. b	—	—	141. b	—	—	185. b	—	—
10. c	—	—	54. d	—	—	98. c	—	—	142. b	—	—	186. c	—	—
11. c	—	—	55. c	—	—	99. c	—	—	143. a	—	—	187. b	—	—
12. a	—	—	56. b	—	—	100. c	—	—	144. a	—	—	188. a	—	—
13. b	—	—	57. d	—	—	101. a	—	—	145. a	—	—	189. c	—	—
14. a	—	—	58. a	—	—	102. a	—	—	146. a	—	—	190. b	—	—
15. b	—	—	59. d	—	—	103. b	—	—	147. d	—	—	191. c	—	—
16. c	—	—	60. d	—	—	104. a	—	—	148. d	—	—	192. b	—	—
17. b	—	—	61. a	—	—	105. d	—	—	149. c	—	—	193. b	—	—
18. d	—	—	62. b	—	—	106. a	—	—	150. a	—	—	194. b	—	—
19. a	—	—	63. c	—	—	107. d	—	—	151. b	—	—	195. a	—	—
20. b	—	—	64. a	—	—	108. d	—	—	152. a	—	—	196. a	—	—
21. a	—	—	65. d	—	—	109. a	—	—	153. a	—	—	197. d	—	—
22. d	—	—	66. a	—	—	110. b	—	—	154. c	—	—	198. a	—	—
23. c	—	—	67. d	—	—	111. a	—	—	155. c	—	—	199. b	—	—
24. c	—	—	68. a	—	—	112. a	—	—	156. d	—	—	200. c	—	—
25. d	—	—	69. d	—	—	113. b	—	—	157. a	—	—	201. b	—	—
26. b	—	—	70. d	—	—	114. c	—	—	158. d	—	—	202. a	—	—
27. a	—	—	71. a	—	—	115. c	—	—	159. d	—	—	203. b	—	—
28. b	—	—	72. d	—	—	116. a	—	—	160. d	—	—	204. b	—	—
29. b	—	—	73. d	—	—	117. b	—	—	161. a	—	—	205. b	—	—
30. d	—	—	74. c	—	—	118. a	—	—	162. d	—	—	206. c	—	—
31. c	—	—	75. d	—	—	119. a	—	—	163. d	—	—	207. c	—	—
32. d	—	—	76. c	—	—	120. c	—	—	164. d	—	—			
33. a	—	—	77. d	—	—	121. a	—	—	165. b	—	—			
34. c	—	—	78. d	—	—	122. c	—	—	166. c	—	—			
35. d	—	—	79. c	—	—	123. a	—	—	167. a	—	—			
36. d	—	—	80. d	—	—	124. a	—	—	168. a	—	—			
37. b	—	—	81. a	—	—	125. c	—	—	169. a	—	—			
38. b	—	—	82. d	—	—	126. c	—	—	170. c	—	—			
39. b	—	—	83. b	—	—	127. c	—	—	171. a	—	—			
40. c	—	—	84. d	—	—	128. a	—	—	172. a	—	—			
41. c	—	—	85. d	—	—	129. d	—	—	173. b	—	—			
42. d	—	—	86. c	—	—	130. d	—	—	174. c	—	—			
43. b	—	—	87. b	—	—	131. d	—	—	175. a	—	—			
44. b	—	—	88. a	—	—	132. d	—	—	176. b	—	—			
												1st: ___/207 = ___%		
												2nd: ___/207 = ___%		

Explanations

1. (a) The requirement is to identify the statement in the standard audit report that indicates the existence of audit risk. Answer (a) is correct because the existence of audit risk is recognized by the statement in the auditor's standard report that the auditor obtained "reasonable assurance." Answer (b) is incorrect because while the standard report does indicate

that the CPA assesses the accounting principles used and the overall financial statement presentation, this does not indicate the existence of audit risk. Answer (c) is incorrect because while the standard report does indicate that the audit relates to whether the financial statements are free of material misstatement, it does not discuss materiality and the audit risk associated with materiality. Answer (d) is incorrect because while the financial statements are the responsibility

of management and the CPA's responsibility is to express an opinion, the indication that the CPA expresses an opinion does not address audit risk and is less precise than the statement that the auditor obtains reasonable assurance.

2. (b) The requirement is to determine an accountant's reporting responsibility when more than one level of service concerning the financial statements of a nonissuer (nonpublic) entity has been performed. Answer (b) is correct because the professional standards that the accountant report on the highest level of service rendered. Answer (a) is incorrect because the highest, and not the lowest, level is reported on. Answer (c) is incorrect because regardless of the other type of service performed, the compilation level is always the lowest level and therefore should not be the basis of the report. Answer (d) is incorrect because in circumstances in which an audit has been performed, an audit report, not a review report, is appropriate.

3. (a) The requirement is to determine the proper addressee of a report in a circumstance in which one company has hired a CPA to audit another company's financial statements. Answer (a) is correct because while audit reports are ordinarily addressed to the company whose financial statements are being audited, when a CPA audits the financial statements of a company that is not his or her client (as is the case here) the report is addressed to the company that hired the CPA.

4. (c) The requirement is to identify the statement that is included in the auditor's standard report. Answer (c) is correct because the auditor's standard report states that an audit includes assessing significant estimates made by management; the other replies provide information not directly mentioned in a standard report.

5. (c) The requirement is to identify which section of the audit report the auditor speaks of the adequacy of audit evidence. Answer (a) is correct because in the auditor's responsibility section the auditor states a belief that the audit evidence obtained is sufficient and appropriate to provide a basis for the audit opinion.

6. (b) The requirement is to identify the correct statement concerning where a statement that the auditor has audited the financial statements which are then listed is included in the audit report. Answer (b) is correct because the opening (introductory) paragraph of the auditor's standard report states that the auditor has audited the financial statements and then lists them. Answer (a) is incorrect because of the explicit statement in the introductory paragraph. Answers (c) and (d) are incorrect because the introductory paragraph, not the auditor's responsibility section or the opinion paragraph, includes the statement and lists the financial statements.

7. (d) The requirement is to determine the representations made explicitly and implicitly when issuing a public company standard auditor's report on comparative financial statements. Answer (d) is correct because that audit report explicitly states that the examination of evidence is made on a test basis and implicitly assumes consistent application of accounting principles. Answer (a) is incorrect because consistency of application of accounting principles is not indicated explicitly. Answer (b) is incorrect because examination of evidence on a test basis is referred to explicitly. Answer (c) is incorrect

because examination of evidence on a test basis is explicitly referred to and because consistent application of accounting principles is not explicitly referred to.

8. (a) The requirement is to determine the meaning of the expression "taken as a whole" in the fourth generally accepted auditing standard of reporting. The professional standards state that "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement.

9. (a) The requirement is to determine the accounting principles that an issuer (public) company audit report refers to. Answer (a) is correct because the financial statements follow generally accepted accounting principles. Answer (b) is incorrect because, while the audit is performed in accordance with PCAOB standards, the financial statements do not follow those standards. Answer (c) is incorrect because the financial statements do not follow generally accepted auditing standards. Answer (d) is incorrect because the financial statements ordinarily follow generally accepted accounting principles, not International Accounting Standards.

10. (c) The requirement is to identify the incorrect statement concerning information included in an audit report of financial statements issued under the requirements of the PCAOB. Answer (c) is correct since the report should refer to the auditor's report on internal control, not on compliance with laws and regulations. Answer (a) is incorrect because the report should include the title "Report of Independent Registered Public Accounting Firm." Answer (b) is incorrect because the report should refer to the standards of the PCAOB. Answer (d) is incorrect because the report should contain the city and state or country of the office that issued the report.

11. (c) The requirement is to determine whether the term "reasonable period of time, not to exceed one year" and/or "going concern" is included in an emphasis-of-matter paragraph relating to going concern status. Answer (c) is correct because while the term "going concern" must be included, the first term is not included in such a report.

12. (a) The requirement is to determine an auditor's reporting responsibility when reporting on comparative financial statements in which the first year presented originally received a going concern modification on a matter that has now been resolved, thus removing the auditor's substantial doubt. Answer (a) is correct because if substantial doubt has been removed in the current period, the emphasis-of-matter paragraph included in the auditor's report on the financial statements of the prior period should not be repeated. Answers (b), (c), and (d) are all incorrect because the paragraph should not be repeated given the changed circumstances.

13. (b) The requirement is to determine the auditor's responsibility when s/he concludes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. Answer (b) is correct because when the auditor concludes there is substantial doubt, s/he should consider the possible effects on the financial statements, and the adequacy of the related disclosures. Answer (a) is incorrect because either an unmodified opinion with an emphasis-of-matter paragraph or a disclaimer is generally appropriate, not a qualified or adverse opinion. Answer (c) is incorrect

because the substantial doubt of going concern status does not require adjusting accounting estimates. Answer (d) is incorrect because the prior year's audit report need not be reissued with an emphasis-of-matter paragraph.

14. (a) The requirement is to determine an auditor's reporting responsibility when there is substantial doubt about a client's ability to continue as a going concern. Answer (a) is correct because the audit report must include an emphasis-of-matter paragraph following the opinion paragraph, and must use the terms "going concern" and "substantial doubt."

15. (b) The requirement is to identify the situation in which an emphasis-of-matter paragraph may be added to an unmodified report. Answer (b) is correct because substantial doubt about the entity's ability to continue as a going concern leads to either an unmodified report with an emphasis-of-matter paragraph or a disclaimer of opinion. Answer (a) is incorrect because an auditor may issue an opinion on a balance sheet without reporting on the other basic financial statements. Answer (c) is incorrect because unreasonable estimates lead to either a qualified or an adverse opinion. Answer (d) is incorrect because inadequate management record retention policies are a scope limitation that may result in a qualified opinion or a disclaimer.

16. (c) The requirement is to identify the management plan an auditor would **most** likely positively consider when a question concerning an entity's ability to continue as a going concern exists. Answer (c) is correct because increasing the ownership equity will bring in funds to possibly overcome the negative trends and financial difficulties. Answers (a), (b), and (d) are all incorrect because increasing dividend distributions, reducing lines of credit, and purchasing assets will all use funds, they will not provide funds. See AU-C 570 for guidance on an auditor's consideration of an entity's ability to continue as a going concern.

17. (b) The requirement is to identify the condition or event **most** likely to cause an auditor to have substantial doubt about an entity's ability to continue as a going concern. Answer (b) is correct because denial of usual trade from suppliers is ordinarily an indicator that the company is in weak financial condition. Answer (a) is incorrect because while such related-party transactions may be considered risky, there is less likely to be a question concerning going concern status than suggested by answer (a). Answer (c) is incorrect because the payment of such stock dividends does not indicate financial weakness. Answer (d) is incorrect because restrictions on the disposal of principal assets is a condition often present in various loan agreements.

18. (d) The requirement is to identify the **most** likely mitigating factor a CPA would consider when a client's ability to continue as a going concern is in question. Answer (d) is correct because the ability to postpone expenditures for research and development projects may mitigate the circumstance. Answer (a) is incorrect because there is no guarantee that Zero's discussions with its lenders will lead to a restructuring of the debt and loan agreements. Only existing or committee agreements to restructure the debt would be considered a mitigating factor. Answer (b) is incorrect be-

cause weak internal control over cash disbursements may or may not have caused the going concern problem. Answer (c) is incorrect because an entity with a going concern problem is unlikely to be able to purchase such production facilities.

19. (a) The requirement is to identify the condition or event that is **most** likely to cause an auditor to have substantial doubt about an entity's ability to continue as a going concern. Answer (a) is correct because the professional standards (as well as logic) includes negative cash flows as one of its examples of such conditions and events. Answer (b) is incorrect because while the postponement of research and development projects may sometimes be due to extreme financial difficulties, often it is not. Answers (c) and (d) are incorrect because neither significant related-party transactions nor stock dividends need not indicate substantial doubt about an entity's ability to continue as a going concern. See AU-C 570 for information on an auditor's consideration of an entity's ability to continue as a going concern.

20. (b) The requirement is to identify the condition or event that might indicate to an auditor substantial doubt about an entity's ability to continue as a going concern. Answer (b) is correct because confirmation with related and third parties of the details of arrangements to provide or maintain financial support is a procedure that would assist an auditor in identifying a question concerning going concern status. See AU-C 570 for this and other such conditions and events indicating doubt about an entity's ability to continue as a going concern. Answer (a) is incorrect because the pledging of assets as collateral is a normal business transaction and it need not necessarily indicate a question of going concern status. Answer (c) is incorrect because reconciling the cash balances with the cutoff bank statement is an acceptable audit procedure, but will not normally identify a going concern question. Answer (d) is incorrect because comparing an entity's depreciation and asset capitalization policies will not normally indicate a question of going concern status.

21. (a) The requirement is to identify the audit procedure **most** likely to assist an auditor in identifying conditions and events that may indicate there could be substantial doubt about an entity's ability to continue as a going concern. Answer (a) is correct because a review of compliance with terms of debt and loan agreements may reveal conditions of noncompliance due to poor financial condition. See the outline of AU-C 570 for a list of procedures that may identify such conditions and events. Answers (b), (c), and (d) are all incorrect because, while they might in some circumstances reveal a question concerning the company's ability to continue as a going concern, they are not considered to be as effective as answer (a).

22. (d) The requirement is to identify the factor which a CPA would **most** likely consider as mitigating substantial doubt about the ability of an entity to continue as a going concern. Answer (d) is correct because management's ability to negotiate reductions of required dividends will decrease required cash outflows, and thereby increase the likelihood that the entity will be able to continue as a going concern. AU-C 570 provides examples of information that might mitigate such concern. Answers (a), (b), and (c) are all incorrect because they involve spending cash, rather than reducing outflows of cash.

23. (c) The requirement is to identify the circumstance **most** likely to mitigate an auditor's substantial doubt about an entity's ability to continue as a going concern. Answer (c) is correct because the marketable assets that management intends to sell may potentially provide the necessary financial resources to mitigate the substantial doubt about the entity's ability to continue as a going concern. Answer (a) is incorrect because the ability to expand operations into new product lines is a suspect circumstance, given the substantial doubt about the entity's ability to continue as a going concern. Answer (b) is incorrect because it also requires cash resources which may not be available. Answer (d) is incorrect because converting preferred stock to long-term debt will not generally alleviate a question concerning an entity's ability to continue as a going concern.

24. (c) The requirement is to identify the circumstances in which an auditor would issue a report that omits any reference to consistency. Answer (c) is correct because a change in the useful life of assets is a change in estimate, and a change in estimate does not result in a consistency modification. Answers (a) and (b) are incorrect because they both represent a change in accounting principle, and a change in accounting principle requires a consistency modification. Answer (d) is incorrect because management's lack of reasonable justification for a change in accounting principle is a departure from generally accepted accounting principles, and the description of the departure will discuss the inconsistency.

25. (d) The requirement is to determine whether an unjustified accounting change, a material weakness in internal control, or both, would cause an auditor to express an unmodified opinion with an emphasis-of-matter paragraph. Answer (d) is correct because an unjustified accounting change will result in either a qualified or an adverse opinion and a material weakness will ordinarily result in no report modification (see AU-C 265 for information on the treatment of material weaknesses); accordingly, an unmodified opinion with an emphasis-of-matter paragraph added to the auditor's report is not appropriate in either case.

26. (b) The requirement is to identify the circumstance in which a disclaimer of opinion is **not** appropriate. Answer (b) is correct because when management does **not** provide reasonable justification of a change in accounting principles either a qualified or an adverse opinion is appropriate, not a disclaimer. Answers (a), (c), and (d) are all incorrect because they represent scope limitations that lead to either a qualified opinion or a disclaimer of opinion.

27. (a) The requirement is to determine the effect on an audit report of a client's decision to use differing inventory costing methods for various portions of its inventory. Answer (a) is correct because a standard unmodified opinion may ordinarily be issued (see AU-C 708 for a discussion of the consistency standard). Answer (b) is incorrect because there is no lack of consistency between accounting periods. Answer (c) is incorrect because there is no departure from GAAP. Answer (d) is incorrect because adverse opinions are only issued when a departure from GAAP exists that makes the financial statements misleading.

28. (b) The requirement is to identify an auditor's reporting responsibility when performing a first audit of a new client and when the auditor was able to extend auditing procedures to gather sufficient evidence about consistency. Answer (b) is correct because, when the auditor has obtained assurance as to the consistency of application of accounting principles between the current and preceding year, no mention of consistency is included in the audit report. Answer (a) is incorrect because the auditor may report on the client's income statement. Answer (c) is incorrect because the consistency standard does apply. Answer (d) is incorrect because the auditor does not refer to consistency when accounting principles have been applied consistently.

29. (b) The requirement is to determine auditor reporting responsibility when management does not provide reasonable justification for a change in accounting principle and presents comparative financial statements. Answer (b) is correct because the auditor should continue to express his/her exception with the financial statements for the year of change as long as they are presented and reported on. Answer (a) is incorrect because the auditor must express his/her exception for as long as the financial statements for the year of change are presented and reported on. Answer (c) is incorrect because the auditor need not qualify the report until management changes back to the accounting principle formerly used. Answer (d) is incorrect because the qualification is necessary despite the fact that the principle is generally accepted.

30. (d) The requirement is to determine the information that must be presented when a client has changed accounting principles. Answer (d) is correct because in addition to identifying the nature of the change, the auditor must refer to the financial statement note that discusses the change in detail. Answer (a) is incorrect because while the auditor must believe that the change is justified, it is not necessary to explain it in the report. Answer (b) is incorrect because the cumulative effect of the change need not be described in the audit report. Answer (c) is incorrect because the auditor need not make explicit concurrence with the change.

31. (c) The requirement is to determine the proper reporting option for a change in accounting principles with an immaterial current year effect, but which is expected to have a substantial effect in subsequent years. Answer (c) is correct because the auditor need not recognize the change in the audit report and may issue a standard unmodified opinion.

32. (d) The requirement is to identify the proper audit report relating to an uncertainty arising due to litigation. Answer (d) is correct because an uncertainty may result in either a qualified opinion with an emphasis-of-matter paragraph or a disclaimer. Answer (a) is incorrect because an adverse opinion is not appropriate. Answers (c) and (b) are incorrect because a qualified opinion is not appropriate.

33. (a) The requirement is to determine the appropriate date for an audit report when a subsequent event requiring adjustment of financial statements, without disclosure of the event, comes to the auditor's attention. The professional standards state that the date sufficient appropriate audit evidence has been collected should be used in such circumstances.

34. (c) The requirement is to determine an auditor's responsibility for subsequent events when an audit report has been dual dated for a subsequent event. Answer (c) is correct because, when dual dating is used, auditor responsibility for events subsequent to the completion of fieldwork is limited to the specific event referred to in the notes to the financial statement. Answers (a), (b), and (d) are all incorrect because they establish more responsibility than required by the professional standards. Note, however, that if the auditor chooses to date the report as of the date of the subsequent event, his/her responsibility for other subsequent events extends to the date of the audit report.

35. (d) The requirement is to identify the proper statement about an audit report that includes a separate paragraph in an otherwise unmodified report that emphasizes that the entity being reported on had significant transactions with related parties. Answer (d) is correct because such emphasis of a matter does not negate the unmodified opinion. Answer (a) is incorrect because the report is considered unmodified. Answer (b) is incorrect because such emphasis of a matter does not violate generally accepted auditing standards if this information is disclosed in notes to the financial statements. Answer (c) is incorrect because the report should **not** include the phrase "with the foregoing explanation."

36. (d) The requirement is to determine whether the terms "when read in conjunction with Note X," and "with the foregoing explanation" should be included in the opinion paragraph of a qualified opinion. The professional standards state that an audit report with a qualified opinion should **not** include either phrase in the opinion paragraph.

37. (b) The requirement is to identify the situation in which an auditor may **not** issue a qualified opinion. Answer (b) is correct because the auditor who lacks independence must disclaim an opinion, not qualify an opinion. Answer (a) is incorrect because a departure from GAAP will result in either a qualified opinion or an adverse opinion. Answer (c) is incorrect because scope limitations result in either a qualified opinion or a disclaimer of opinion. Answer (d) is incorrect because a specialist may be referred to when an auditor is issuing a qualified opinion, an adverse opinion, or a disclaimer of opinion.

38. (b) The requirement is to identify the information that should be included in the opinion paragraph of an audit report with an adverse opinion. Answer (b) is correct because the opinion paragraph should include a direct reference to a separate paragraph disclosing the basis for the opinion. Answer (a) is incorrect because the principal effects, if available, should be described in a separate emphasis-of-matter paragraph, and not in the opinion paragraph. Answer (c) is incorrect because while a separate paragraph provides a description of the substantive reasons for the adverse opinion, the opinion paragraph does not. Answer (d) is incorrect because neither an uncertainty nor a scope limitation leads to an adverse opinion.

39. (b) The requirement is to identify the appropriate types of audit reports when an illegal act with a material effect on the financial statements has not been properly accounted for or

disclosed. Answer (b) is correct because omission of required disclosures, a departure from generally accepted accounting principles, leads to either a qualified or an adverse opinion. Answer (a) is incorrect because a disclaimer of opinion is not appropriate when the auditor knows of such misstatements. Answer (c) is incorrect because neither a disclaimer of opinion nor an unmodified opinion with a separate emphasis-of-matter paragraph is appropriate. Answer (d) is incorrect because an unmodified opinion with a separate emphasis-of-matter paragraph is not appropriate.

40. (c) The requirement is to identify the phrase that an auditor would include in an audit report with a qualified opinion because of inadequate disclosure. Answer (c) is correct because the phrase "except for the omission of the information discussed in the opinion paragraph" is the proper phrase. Answers (a), (b), and (d) are all incorrect because they are phrases not allowed in reports with qualified opinions.

41. (c) The requirement is to identify the circumstance that would **most** likely result in an auditor expressing an adverse opinion. Answer (c) is correct because departures from GAAP, such as inappropriately reporting leases, result in either a qualified or an adverse opinion. Answer (a) is incorrect because client refusal to provide access to minutes is a client imposed scope limitation that will normally result in a disclaimer of opinion. Answer (b) is incorrect because weak internal control will not in general result in an adverse opinion; if controls are so weak that an audit cannot effectively be completed, a disclaimer of opinion or withdrawal may be appropriate. Answer (d) is incorrect because substantial doubt about going concern status results in either an unmodified opinion with an emphasis-of-matter paragraph or a disclaimer of opinion.

42. (d) The requirement is to identify the paragraphs of an audit report that are modified when an auditor qualifies an opinion because of inadequate disclosure. In addition to requiring the inclusion of a separate basis for qualification matter paragraph, AU-C 705 indicates that only the opinion paragraph should be modified.

43. (b) The requirement is to determine the appropriate report modification that results when the management of a publicly held company issues financial statements that purport to present its financial position and results of operations but omits the statement of cash flows. Answer (b) is correct because failure to include a statement of cash flows in such a circumstance is considered a departure from GAAP and the appropriate choice here is a qualified opinion.

44. (b) The requirement is to identify the circumstance in which an auditor will choose between expressing an "except for" qualified opinion and an adverse opinion. Answer (b) is correct because omissions of required information, a departure from generally accepted accounting principles, leads to either a qualified or an adverse opinion. Answer (a) is incorrect because a scope limitation such as the failure to observe a client's physical inventory leads to either a qualified opinion or a disclaimer of opinion. Answer (c) is incorrect because an auditor may issue an unmodified opinion on one statement. Answer (d) is incorrect because substantial doubt about an

entity's ability to continue as a going concern leads to either an unmodified report with explanatory language or a disclaimer of opinion.

45. (b) The requirement is to identify the situation in which an auditor will ordinarily choose between expressing a qualified opinion or an adverse opinion. Answer (b) is correct because departures from generally accepted accounting principles result in either a qualified opinion or an adverse opinion—such lack of disclosure is a departure from generally accepted accounting principles. Answer (a) is incorrect because the inability to observe the physical inventory and inability to become satisfied about its balance represents a scope limitation that will result in either a qualified opinion or a disclaimer of opinion. Answer (c) is incorrect because a change in accounting principles leads to an unmodified opinion with an emphasis-of-matter paragraph added to the report. Answer (d) is incorrect because inability to apply necessary procedures represents a scope limitation that will result in either a qualified opinion or a disclaimer of opinion.

46. (a) The requirement is to identify the type of opinion that should be issued on the financial statements when an auditor has been unable to obtain sufficient evidence relating to the consistent application of accounting principles between the current and prior year. Answer (a) is correct because the scope limitation will affect the year's beginning balances and thereby affect the current year's results of operations and cash flows. Answer (b) is incorrect because the year-end balance sheet will be unaffected by the scope limitation (any retained earnings misstatement of the preceding year will be offset in the current year). Answer (c) is incorrect because the auditor need not withdraw in such circumstances. Answer (d) is incorrect because this situation represents a scope limitation, and not an uncertainty.

47. (d) The requirement is to identify the circumstance in which an auditor would **not** express an unmodified opinion. Answer (d) is correct because an inability to obtain the audited financial statements of a consolidated investee represents a scope limitation, and a significant scope limitation results in either a qualified opinion or a disclaimer of opinion. Answer (a) is incorrect because a material change between periods in accounting principles will result in an emphasis-of-matter paragraph being added to a report with an unmodified opinion. Answer (b) is incorrect because the omission of the SEC required quarterly financial data, which is considered "unaudited," results in a report with an unmodified opinion with an emphasis-of-matter paragraph. Answer (c) is incorrect because an auditor's emphasis of an unusually important subsequent event results in a report with an unmodified opinion with an emphasis-of-matter paragraph.

48. (a) The requirement is to determine the propriety of including a statement that the current asset portion of an entity's balance sheet was fairly stated in an audit report that disclaims an opinion on the overall financial statements. Answer (a) is correct because expressions of opinion as to certain identified items in financial statements (referred to as "piecemeal opinions") should not be expressed when the auditor has disclaimed an opinion or has expressed an adverse opinion. Such opinions tend to overshadow or contradict the

disclaimer or adverse opinion. Answer (b) is incorrect because an auditor may report on one basic financial statement. Answers (c) and (d) are incorrect because providing such assurance is **not** appropriate.

49. (b) The requirement is to identify the type of opinion that should be issued on the balance sheet and the income statement when an auditor did not observe a client's taking of the beginning physical inventory and was unable to become satisfied about its accuracy by using other auditing procedures. Answer (b) is correct because the scope limitation will not affect the year-end balance sheet account balances. However, because evidence with respect to the beginning inventory is lacking, verification of cost of goods sold, an income statement element, is impossible. Although year-end retained earnings will not be affected, both the current and prior years' retained earnings statements will be affected (by an offsetting amount) by the cost of goods sold misstatement. If no other problems arise, the auditor will be able to issue an unmodified opinion on the balance sheet and a disclaimer on the income statement (and on the retained earnings statement). Answer (a) is incorrect because an unmodified opinion may be issued on the balance sheet. Answer (c) is incorrect because an unmodified opinion may be issued on the balance sheet with a disclaimer on the income statement. Answer (d) is incorrect because a disclaimer should be issued on the income statement.

50. (c) The requirement is to determine whether the auditor responsibility section, opinion paragraph, and/or notes to the financial statements should refer to an audit scope limitation. Answer (c) is correct because the suggested report presented for a scope limitation includes modification of both the scope and opinion paragraphs. In addition, it is not appropriate for the scope of the audit to be explained in a note to the financial statements.

51. (c) The requirement is to identify a CPA's responsibility when asked to report on only one financial statement. Answer (c) is correct because the auditor may accept the engagement because the situation involves limited reporting objectives, not a limitation on the scope of audit procedures. Answers (a), (b), and (d) are incorrect because the auditor is able to accept such an engagement and because the auditor is able to apply the procedures considered necessary.

52. (d) The requirement is to determine whether either the auditor's responsibility section, the opinion paragraph, or both should be deleted when an auditor is disclaiming an opinion due to a client-imposed scope limitation. Answer (d) is correct because neither the auditor responsibility section nor the opinion paragraph is deleted, although they are both modified. Answer (a) is incorrect because it suggests that the opinion paragraph is omitted. Answer (b) is incorrect because it states that both the auditor responsibility paragraph and the opinion paragraph are omitted. Answer (c) is incorrect because it states that the opinion paragraph is omitted.

53. (c) The requirement is to identify the information included in the opinion paragraph of an auditor's report that is qualified due to a major inadequacy in the computerized accounting records. Answer (c) is correct because the opinion paragraph indicates that the exception is due to the possible

effects on the financial statements. Answer (a) is incorrect because the opinion paragraph will not include a reference to client-imposed scope limitations. Answer (b) is incorrect because no indication of a departure from generally accepted auditing standards is provided in the opinion paragraph and this situation is not a departure from GAAS. Answer (d) is incorrect because there is no indication that there is inadequate disclosure of necessary information.

54. (d) The requirement is to identify the circumstance in which a scope limitation is sufficient to preclude an unmodified opinion. Answer (d) is correct because AU-C 580 states that management's refusal to furnish such a written representation constitutes a limitation on the scope of an audit sufficient to preclude an unmodified opinion. Answers (a), (b), and (c) are all incorrect because while they represent scope limitations, they may sometimes not result in a report that is other than unmodified.

55. (c) The requirement is to determine the proper audit report when an auditor has doubt as to the integrity of management and the representations obtained from management and has not decided to resign. Answer (c) is correct because the professional standards consider this as a scope limitation and accordingly its significant nature makes a disclaimer **most** likely. Answer (a) is incorrect because an unmodified opinion is not appropriate due to the lack of sufficient appropriate audit evidence due to the doubt concerning management's integrity. Answer (b) is incorrect because the lack of confidence in management's integrity makes an unmodified opinion inappropriate. Answer (d) is incorrect because the auditor is not aware of significant misstatements that would lead to an adverse opinion.

56. (b) The requirement is to determine the situation in which an auditor would ordinarily issue an unmodified audit opinion without an emphasis-of-matter paragraph. Answer (b) is correct because when an auditor makes reference to the report of another auditor no additional paragraph is added to the report. Answer (a) is incorrect because emphasizing that the entity had significant related-party transactions is normally accomplished through the addition of an emphasis-of-matter paragraph. Answer (c) is incorrect because the omission of a statement of cash flows when an entity issues financial statements that present financial position and result of operations results in a qualified audit opinion with basis for qualified opinion paragraph. Answer (d) is incorrect because substantial doubt about the entity's ability to continue as a going concern normally results in either an unmodified opinion with an emphasis-of-matter paragraph or a disclaimer of opinion.

57. (d) The requirement is to determine a group engagement partner's responsibility, in addition to making inquiries of the other auditor's reputation and independence, after having decided **not** to refer to the audit of the component (other) auditor. Answer (d) is correct because when a decision is made **not** to make reference to the component auditor—that is, to take responsibility for that auditor's work—the group auditor should perform additional procedures dependent upon the significance of the component. Answer (a) is incorrect because no emphasis-of-matter paragraph is added to the audit report. Answer (b) is incorrect because the group engagement

partner is assuming responsibility for the component auditor's work when a decision is made not to refer to the component auditor's report. Answer (c) is incorrect because written permission is not required when the group engagement partner is taking responsibility for the work of the other auditor.

58. (a) The requirement is to determine the meaning of sentences added to the auditor responsibility section of an auditor's report that states that another auditor audited a portion of the entity. Answer (a) is correct because the professional standards provide that such a statement indicates a division of responsibility. Answer (b) is incorrect because when the other auditor is referred to the CPA, the CPA is not assuming responsibility for the other auditor. Answer (c) is incorrect because an unmodified opinion may be issued. Answer (d) is incorrect because the sentences are proper.

59. (d) The requirement is to identify the situation in which an auditor may issue the standard audit report. Answer (d) is correct because a standard report may be issued in circumstances in which the principal auditor assumes responsibility for the work of another auditor. Answer (a) is incorrect because the standard report does not include reference to a specialist. Thus, reference to a specialist within a report by definition causes modification of the standard report. Answer (b) is incorrect because the auditor is required to issue a modified report on condensed financial statements. Answer (c) is incorrect because audit reports on financial statements prepared using a financial reporting framework other than GAAP require departures from the standard form.

60. (d) The requirement is to determine a group engagement partner's reporting responsibility when a decision has been made to not make reference to a component auditor who has audited a client's subsidiary. Answer (d) is correct because, regardless of whether the component auditor is referred to, the group engagement partner must be satisfied as to the independence and professional reputation of the other CPA. Answer (a) is incorrect because the group engagement partner need not issue an unmodified opinion on the consolidated financial statements. Answer (b) is incorrect because it is not necessary that the component auditor issue an unmodified opinion on the subsidiary's financial statements. Answer (c) is incorrect because the group engagement partner should consider a variety of procedures depending upon the significance of the subsidiary when a decision is made to not make reference to the component auditor.

61. (a) The requirement is to determine the type of opinion to be issued when financial statements of an entity that follows GASB standards include a justified departure from GAAP. Answer (a) is correct because the auditor should issue an unmodified opinion and should include a separate emphasis-of-matter paragraph explaining the departure from GAAP. Answers (b), (c), and (d) are incorrect because when the auditor believes that the departure is justified, neither a qualified nor adverse opinion is appropriate.

62. (b) The requirement is to determine which auditor(s) is (are) responsible for evaluating the appropriateness of the adjustment of foreign financial statements consolidated with

US GAAP financial statements in a group audit situation.

Answer (b) is correct because the group auditor is responsible. Answer (a) is incorrect because the component auditor is not responsible. Answer (c) is incorrect because the group auditor is responsible and the component auditor is not. Answer (d) is incorrect because the group auditor is responsible.

63. (c) The requirement is to determine the proper date of a reissued audit report on financial statements that have **not** been restated. Answer (c) is correct because use of the original date on the reissued audit report removes any implication that records, transactions or events after the date of the audit report have been examined or reviewed.

64. (a) The requirement is to identify the circumstance in which an auditor reporting on comparative financial statements would ordinarily change the previously issued opinion on the prior year's financial statements. Answer (a) is correct because when an auditor has previously expressed a qualified or an adverse opinion on financial statements of a prior period and those financial statements have been restated, the auditor's updated report is changed. Answer (b) is incorrect because, ordinarily, the reissued report by a predecessor auditor will be the same as that originally issued. Answer (c) is incorrect because the prior year's opinion will remain unmodified if the current year's audit report is modified due to a lack of consistency. Answer (d) is incorrect because restatement of prior year's financial statements following a pooling of interest will not lead to a change in the previously issued opinion.

65. (d) The requirement is to determine the information to be included in an audit report on comparative financial statements when a predecessor auditor's report is not being reissued. Answer (d) is correct because an other-matter paragraph should be added to the successor's report and it should indicate (1) that the financial statements of the prior period were audited by another auditor (whose name is not presented), (2) the date of the predecessor's report, (3) the type of report issued by the predecessor, and (4) if the report was other than a standard report, the substantive reasons therefor.

66. (a) The requirement is to determine whether the predecessor auditor should obtain a representation letter from management, the successor auditor, or both, before reissuing the prior year's audit record. Answer (a) is correct because the predecessor auditor should obtain a representation letter from both management and the successor auditor.

67. (d) The requirement is to identify the circumstance in which a standard unmodified report may be issued when single-year financial statements are presented. Answer (d) is correct because when the prior year's financial statements are not being presented, the CPA need not refer to them or include the predecessor auditor's report. Answer (a) is incorrect because inability to audit an investment in a foreign affiliate is a scope limitation that is likely to result in either a qualified opinion or a disclaimer. Answer (b) is incorrect because a qualified opinion is appropriate when an entity declines to present a statement of cash flows with its balance sheet and related statements of income and retained earnings.

Answer (c) is incorrect because the emphasis of an accounting matter by an auditor results in inclusion of an emphasis-of-matter paragraph to the unmodified audit report.

68. (a) The requirement is to identify the correct form of an audit report on comparative financial statements when a continuing auditor has audited the two years of financial statements being presented. Answer (a) is correct because one audit report should be issued that includes the years involved. Answer (b) is incorrect because one report, not two reports, should be issued. Answer (c) is incorrect because both years should be reported upon. Answer (d) is incorrect because auditors do not have the option of issuing two audit reports in this circumstance.

69. (d) The requirement is to determine the manner in which a predecessor auditor who has reissued a report for comparative financial statements should refer to the successor auditor. The predecessor auditor should not refer in the reissued report to the report or work of the successor auditor.

70. (d) The requirement is to determine the proper reporting procedure for comparative financial statements for which the prior year is compiled, and the current year is audited. When compiled financial statements are presented in comparative form with audited financial statements, the report on the prior period may be reissued to accompany the current period report. Alternatively, the report on the current period may include a separate paragraph describing responsibility assumed for the prior period financial statements.

71. (a) The requirement is to identify the auditor's reporting responsibility for a material inconsistency between the audited financial statements and the other information in an annual report to shareholders containing audited financial statements. Answer (a) is correct because AU-C 720 states that if a material inconsistency exists and the client refuses to revise the other information, the auditor should include an emphasis-of-matter paragraph that explains the inconsistency. The auditor may also withhold the use of the audit report or the auditor may withdraw from the engagement. Answer (b) is incorrect because the financial statements are not misstated. Answer (c) is incorrect because the auditor must review the other information to ensure that it is consistent with the financial statements. Answer (d) is incorrect because the financial statements are not misstated and therefore a disclaimer of opinion is inappropriate.

72. (d) The requirement is to determine an auditor's responsibility when audited financial statements are presented in a document containing other information. Answer (d) is correct because the auditor is required to read the other information to determine that it is consistent with the audited financial statements. Answers (a) and (c) are incorrect because no such inquiry, analytical procedures, or other substantive auditing procedures are required. Answer (b) is incorrect because, unless the information seems incorrect or inconsistent with the audited financial statements, no emphasis-of-matter paragraph needs to be added to the auditor's report.

73. (d) The requirement is to identify the manner in which an auditor may express an opinion on an entity's accounts receivable when that auditor has disclaimed an opinion on the

financial statements taken as a whole. Answer (d) is correct because such a report is considered a “specified elements, accounts, or items report,” and should include the opinion on the accounts receivable separately from the disclaimer of opinion on the financial statement. Answer (a) is incorrect because reason for the disclaimer of opinion need not be provided. Answer (b) is incorrect because distribution of such a report is not restricted to internal use only. Answer (c) is incorrect because the auditor need not report on the current asset portion of the entity’s balance sheet to issue such a report.

74. (c) The requirement is to identify an auditor’s responsibility for required supplementary information that is placed outside the basic financial statements. Answer (c) is correct because AU-C 730 requires that the auditor apply limited procedures to the information and report deficiencies in, or the omission of, the information. Answer (a) is incorrect because the auditor does have some responsibility for the supplementary information. Answer (b) is incorrect because the auditor must apply limited procedures to information presented and report deficiencies in the information in addition to determining whether it has been omitted. Answer (d) is incorrect because tests of details of transactions and balances need not be performed.

75. (d) The requirement is to determine the proper audit report when management declines to present supplementary information required by the Governmental Accounting Standards Board. Answer (d) is correct because omission of required supplementary information, which when presented is not considered audited, leads to an unmodified opinion with an other-matter paragraph. Answers (a) and (b) are incorrect because neither an adverse opinion nor a qualified opinion is appropriate since the supplementary information is not audited. Answer (c) is incorrect because it is incomplete since an unmodified opinion with an additional other-matter paragraph is required.

76. (c) The requirement is to identify the correct statement that may be included in an auditor’s report when an auditor provides an opinion on information accompanying the basic financial statements. Answer (c) is correct because the report indicates whether the accompanying information is fairly stated in all material respects in relation to the basic financial statements taken as a whole. Answer (a) is incorrect because the information is not presented in accordance with generally accepted auditing standards. Answer (b) is incorrect because the information is in addition to that required by generally accepted accounting principles. Answer (d) is incorrect because it is not in accordance with attestation standards.

77. (d) The requirement is to determine an auditor’s responsibility for controlling the distribution by the client of a restricted-use report. Answer (d) is correct because the professional standards state that an auditor is not responsible for controlling the distribution of such reports. Answer (a) is incorrect because while an auditor should consider informing a client that restricted-use reports are not intended for such distribution, there is no such requirement and such distribution may or may not be legal. Answer (b) is incorrect because the auditor need not inform the client to cease and desist. Answer

(c) is incorrect because an auditor need not insist that the client not duplicate the restricted-use report.

78. (d) The requirement is to identify the type of report that is **most** likely to include an alert to readers that its use is restricted to certain specified users. Answer (d) is correct because all agreed-upon procedures reports are so restricted. Although audit, review, or compilations reports may be so restricted, there is no requirement that they be.

79. (c) The requirement is to identify the report that is **least** likely to be a restricted-use report. Answer (c) is correct because reports on most financial reporting frameworks other than GAAP are not restricted. Answers (a) and (b) are incorrect because reports on significant deficiencies and reports to audit committees are restricted under the professional standards. Answer (d) is incorrect because a report on compliance is restricted.

80. (d) The requirement is to determine auditor reporting responsibility when prior period financial statements which received a qualified opinion due to a lack of adequate disclosure have been restated to eliminate the lack of disclosure. Answer (d) is correct because an auditor should express an unmodified opinion on the restated financial statements of the prior year (with an emphasis-of-matter paragraph describing the circumstance). Answer (a) is incorrect because the auditor’s original report is not reissued. Answer (b) is incorrect because the qualified opinion is eliminated. Answer (c) is incorrect because reference to the type of opinion expressed is included in the reissued report’s emphasis-of-matter paragraph.

81. (a) The requirement is to identify audit reporting requirements when reporting on financial statements of a US entity prepared in accordance with another country’s accounting principles. Answer (a) is correct because AU-C 910 states that the auditor should understand the accounting principles generally accepted in the other country. Answer (b) is incorrect because the auditor does not have to obtain certification outside of the United States. Answer (c) is incorrect because the auditor does not have to disclaim an opinion. Answer (d) is incorrect because the auditor does not have to receive a waiver from the auditor’s state board of accountancy.

82. (d) The requirement is to determine the appropriate types of reports that may be issued when the financial statements of a US subsidiary are prepared following the principles of a non-US parent company’s country for inclusion in that parent company’s non-US consolidated financial statements. AU-C 910 allows either a modified US style report or the report form of the parent’s country. A US style unmodified report is not appropriate.

83. (b) The requirement is to determine the proper placement of a basis for modification paragraph disclosing the substantive reasons for expressing an adverse opinion. AU-C 705 requires that such paragraphs precede the opinion section (paragraph).

84. (d) The requirement is to determine the information that should be included in an audit report on financial statements prepared on the income tax basis of accounting. AU-C 800 presents the form of the report to be issued. Answer (d) is correct because AU-C 800 requires that the report indicate

that the income tax basis of accounting is a financial reporting framework other than GAAP.

85. (d) The requirement is to identify the appropriate type of audit report to be issued for a nonprofit entity's financial statements prepared following an accounting basis prescribed by a regulatory agency solely for filing with that agency. Answer (d) is correct because an unmodified opinion is appropriate given that the financial statements are fairly presented; the report will include a paragraph indicating that a basis other than GAAP is being followed. Answer (a) is incorrect because an unmodified report may be issued if there are no departures from the prescribed basis. The report would not be qualified because the financial statements were prepared using an accounting basis prescribed by a regulatory agency. Answer (b) is incorrect because an adverse opinion is not appropriate when the information is properly presented. Answer (c) is incorrect because a disclaimer of opinion need not be issued.

86. (c) The requirement is to identify the disclosure included in a separate emphasis-of-matter paragraph of an auditor's report on financial statements prepared in conformity with the cash basis of accounting. Answer (c) is correct because the emphasis-of-matter paragraph refers to the note to the financial statements that describes the basis of accounting. AU-C 800 presents complete details on such reports. Answer (a) is incorrect because the report need not justify the reasons for following a basis other than generally accepted accounting principles. Answer (b) is incorrect because the emphasis-of-matter paragraph contains no statement on fair presentation, and because the opinion paragraph states whether the presentation is in conformity with the basis described in the appropriate financial statement note. Answer (d) is incorrect because no explanation of how the results of operations differ from financial statements prepared in conformity with generally accepted accounting principles is necessary.

87. (b) The requirement is to identify a situation in which an auditor's report would refer to a basis of accounting other than GAAP. AU-C 800 defines reports on compliance with aspects of regulatory requirements related to audited financial statements as special-purpose financial reporting frameworks and requires such identification.

88. (a) The requirement is to determine the type of report to issue when a client who uses a special-purpose financial reporting framework has not appropriately titled its financial statements. Answer (a) is correct because any such exceptions or reservation should be described in an emphasis-of-matter paragraph and possibly a qualified (or adverse) opinion should be issued. Answer (b) is incorrect because no such application to the state insurance commission is necessary. Answer (c) is incorrect because a disclaimer of opinion is not appropriate when known misstatements exist. Answer (d) is incorrect because, as indicated, more than describing the terminology is necessary.

89. (b) The requirement is to identify an auditor's reporting responsibility when a printed form prescribes the wording of the independent auditor's report that will accompany it, but that wording is not acceptable to the auditor. AU-C 800

suggests that the auditor reword the report (or attach a separate report) in this situation.

90. (a) The requirement is to identify a requirement for a CPA to express an opinion on a profit participation plan relating to an entity's net income. Answer (a) is correct because if a specified element is, or is based upon, an entity's net income or stockholders' equity, the CPA should have audited the complete financial statements in order to express an opinion on the element. Answer (b) is incorrect because the financial statements need not be prepared in conformity with GAAP, as other bases of accounting may be followed. Answer (c) is incorrect because the report need not be made available for distribution to other employees. Answer (d) is incorrect because the individual in the profit participation plan need not own a controlling interest in the company.

91. (a) The requirement is to determine whether a CPA is permitted to accept an engagement to audit either a schedule of accounts receivable, a schedule of royalties, or both. Answer (a) is correct because auditors may audit "specified elements, accounts or items of a financial statement," including either a schedule of accounts receivable or a schedule of royalties. Answer (b) is incorrect because an auditor may audit a schedule of royalties. Answer (c) is incorrect because an auditor may audit a schedule of accounts receivable. Answer (d) is incorrect because an auditor may audit both a schedule of accounts receivable and a schedule of royalties.

92. (d) The requirement is to identify the procedure **not** ordinarily included in an accountant's review of interim financial information. Answer (d) is correct because reviews consist largely of inquiries of management and analytical procedures and not corroborating external evidence such as confirmations. Answer (a) is incorrect because the reading of minutes is ordinarily a part of a review. Answer (b) is incorrect because "applying financial ratios" is a form of analytical procedures that may be included in a review. Answer (c) is incorrect because inquiries of accounting department management personnel are appropriate in a review.

93. (b) The requirement is to identify the **least** likely procedure included in an interim review of the financial statements of a public client. Answer (b) is correct because an interim review ordinarily does not include such substantive tests of balances. Answer (a) is incorrect because a CPA should obtain such written representations. Answer (c) is incorrect because the CPA will read the financial statements for obvious material misstatements. Answer (d) is incorrect because the primary procedures included in such a review are analytical procedures and inquiries.

94. (a) The requirement is to identify the objective of a review of interim financial information. Answer (a) is correct because the objective of a review of interim financial information is to provide a basis for reporting on whether material modification should be made for such information to conform with generally accepted accounting principles. Answer (b) is incorrect because no updated opinion is being issued. Answer (c) is incorrect because summary financial statements or pro forma financial information are not being

considered in this question. Answer (d) is incorrect because the statements may or may not be presented in conformity with generally accepted accounting principles.

95. (a) The requirement is to identify the correct statement with respect to an independent accountant's review report on interim financial information presented in a registration statement. Answer (a) is correct because an accountant's review report is **not** a part of the registration statement within the meaning of Section 11 of the Securities Act of 1933. Answer (b) is incorrect because under certain conditions an accountant is required to update the report. Answers (c) and (d) are incorrect because the prospectus includes neither a statement that the review was performed in accordance with SEC standards, nor a statement that the accountant obtained corroborating evidence.

96. (d) The requirement is to determine the circumstances which will lead to a modification of an interim report. Departures from generally accepted accounting principles, which include adequate disclosure, require modification of the accountant's report. Normally neither an uncertainty [answer (a)] nor a lack of consistency [answer (b)] would cause a report modification. Reference to another accountant [answer (c)] is not considered a modification.

97. (b) The requirement is to identify the procedure that would ordinarily be applied when an accountant conducts a review of the interim financial information of a publicly held entity. Answer (b) is correct because the accountant will ordinarily read the minutes of meetings of stockholders, the board of directors, and committees of the board of directors to identify actions that may affect the interim financial information. Answers (a), (c), and (d) are all incorrect because they represent verification procedures typically beyond the scope of a review of interim financial information.

98. (c) The requirement is to identify the **least** likely procedure to be included in an accountant's review of interim financial information of an issuer (public) entity. Answer (c) is correct because a review consists principally of performing analytical procedures and making inquiries, not procedures such as observation, inspection, and confirmation. Answers (a), (b), and (d) are all incorrect because they include review procedures included in the professional standards

99. (c) The requirement is to identify the **most** likely information included in a review report. Answer (c) is correct because the professional standards require that the report include a description of procedures performed. Answer (a) is incorrect because the information was reviewed, not examined, in accordance with standards of the PCAOB. Answer (b) is incorrect because the interim financial information is the responsibility of the entity's management, not the shareholders. Answer (d) is incorrect because a review is less in scope than an audit, not than a compilation.

100. (c) The requirement is to determine the circumstance under which an auditor may report on summary financial statements that are derived from complete audited financial statements. Answer (c) is correct because a report may be issued when the information in the summary financial statements is fairly stated in all material respects in relation to

the financial statements. Answer (a) is incorrect because the summary financial statements need not be distributed with the complete financial statements. Answer (b) is incorrect because the report need not indicate the nature of any additional procedures. Answer (d) is incorrect because prior year summary financial information is not necessary. See AU-C 810 for information on summary financial statements.

101. (a) The requirement is to determine the appropriate response relating to selected financial data that are included in a document containing audited financial statements.

Answer (a) is correct because the selected data should be limited to data derived from the audited financial statements. Answer (b) is incorrect because distribution of the report need not be limited to senior management and the board of directors. Answer (c) is incorrect because the selected data need not follow a financial reporting framework other than GAAP. Answer (d) is incorrect because the report will ordinarily state that the selected data are fairly stated in all material respects in relation to the consolidated financial statements.

102. (a) The requirement is to determine a predecessor auditor's responsibility when the financial statements he or she audited are being included in an SEC registration statement filing. Answer (a) is correct because AU-C 920 requires that the predecessor (1) read pertinent portions of the document, and (2) obtain a letter of representation from the successor auditor.

103. (b) The requirement is to identify the statement that is correct concerning letters for underwriters. Answer (b) is correct because letters for underwriters typically provide negative assurance on unaudited interim financial information. Answer (a) is incorrect because letters for underwriters are not required by the Securities Act of 1933. Answer (c) is incorrect because letters for underwriters are not included in registrations statements. Answer (d) is incorrect because auditors' opinions on the prior year's financial statement are not updated.

104. (a) The requirement is to determine who ordinarily signs a comfort letter. Answer (a) is correct because a comfort letter (also known as letter to an underwriter) is sent by the independent auditor to the underwriter.

105. (d) The requirement is to identify to whom comfort letters are ordinarily addressed. Answer (d) is correct because comfort letters, also referred to as letters for underwriters, are ordinarily addressed to underwriters.

106. (a) The requirement is to determine the type of opinion or assurance provided by an accountant who issues a comfort letter containing comments on data that have **not** been audited. Answer (a) is correct because when procedures short of an audit are applied to information such as capsule information, a comfort letter will generally provide negative assurance. Answer (b) is incorrect because CPAs do not provide positive assurance on supplementary disclosures. Answer (c) is incorrect because no "limited opinion" is issued on pro forma or other information. Answer (d) is incorrect because no disclaimer will be included on the prospective financial statements.

107. (d) The requirement is to determine the appropriate reference to an independent accountant in a prospectus (relating to an SEC registration statement) that includes a

statement about his/her involvement with an independent audit report. AU-C 920 indicates that the independent accountant is an expert in auditing and accounting.

108. (d) The requirement is to identify the information included in a typical comfort letter. Answer (d) is correct because in a comfort letter auditors provide an opinion as to whether the audited financial statements comply in form with the accounting requirements of the SEC. Answer (a) is incorrect because negative assurance concerning whether the entity's internal control procedures operated as designed during the period is not provided. Answer (b) is incorrect because a comfort letter does not include an opinion on whether the entity complied with Government Auditing Standards and the Single Audit Act. Answer (c) is incorrect because negative, not positive, assurance is provided on unaudited summary financial information.

109. (a) The requirement is to determine the proper treatment of unaudited financial statements presented in comparative form with audited financial statements in a document filed with the Securities and Exchange Commission. Answer (a) is correct because those statements should be marked "unaudited," not withheld until they are audited, and not referred to in the auditor's report.

110. (b) The requirement is to identify the requirement relating to a CPA's report when reporting on the application of accounting principles to a specific transaction. Answer (b) is correct because AU-C 915 requires that the report include a statement that responsibility for the proper accounting treatment rests with the preparers of the financial statements. Answer (a) is incorrect because the report states that the engagement was performed in accordance with applicable AICPA standards, not Statements on Standards for Accounting and Review Services. Answer (c) is incorrect as no such statement about opinion-shopping is included. Answer (d) is incorrect because the information may be communicated to a prior or continuing auditor.

111. (a) The requirement is to determine an auditor's reporting responsibility when asked by a prospective client to render an opinion on the application of accounting principles to a specific transaction. Answer (a) is correct because AU-C 915 indicates that the report must include a statement that any difference in the facts, circumstances, or assumptions presented may change the report, as well as various other disclosures. Answer (b) is incorrect because the report indicates that the engagement was performed in accordance with AICPA standards, not Statements on Standards for Consulting Services. Answer (c) is incorrect because the report need **not** indicate that the guidance is for management use only and may not be communicated to the prior or continuing auditors. Answer (d) is incorrect because the report does not include negative assurance ("nothing came to our attention"). See AU-C 915 for performance and reporting requirements relating to reports on the application of accounting principles.

112. (a) The requirement is to determine an auditor's responsibility when asked to render an opinion on the application of accounting principles to a specific transaction by an entity that is audited by another CPA. Answer (a) is correct because the accountant ordinarily must consult with the

continuing CPA to attempt to obtain information relevant to the transaction; an exception to this rule exists under certain circumstances in which the accountant provides recurring services for the entity. Answer (b) is incorrect because the engagement's findings need not be reported to all of the groups listed—the entity's audit committee, the continuing CPA, and management. Answer (c) is incorrect because the accountant need not disclaim an opinion. Answer (d) is incorrect because the report's distribution need not be restricted to management and outside parties who are aware of all relevant facts.

113. (b) Answer (b) is correct because AU-C 915 indicates that an accountant should not undertake such an engagement when the report would be based on such a hypothetical transaction. Answers (a), (c), and (d) are all incorrect because they include information included in an accountant's report on the application of accounting principles.

114. (c) The requirement is to select the service that is **most** likely to be structured as an attest engagement. Answer (c) is correct because CPAs may provide assurance as to compliance with requirements of specified laws through a variety of services, including agreed-upon procedures engagements and various compliance audits. Answers (a) and (b) are incorrect because advocating a client's tax position is **not** typically structured as an attest service. Answer (d) is incorrect because compilation reports do not provide assurance.

115. (c) Answer (c) is correct because AT 101 indicates that an unmodified may ordinarily refer to that assertion or to the subject matter to which the assertion relates. Answer (a) is incorrect because it suggests reporting only on the assertion. Answer (b) is incorrect because it suggests reporting only on the subject matter. Answer (d) is incorrect because it suggests that reporting on neither the assertion nor the subject matter is appropriate. Note, however, that AT 101 also states that when a deviation from the criteria being reported upon exists (e.g., a material weakness in internal control) the CPA should report directly upon the subject matter and not upon the assertion.

116. (a) The requirement is to identify the correct statement. When a standard unmodified examination report is being issued, that report may be upon the subject matter or the written assertion. Answers (b), (c), and (d) are all incorrect because they suggest that the report may not be upon either the subject matter, the written assertion, or both.

117. (b) The requirement is to determine whether a CPA's conclusion may be upon the subject matter, the written assertion, or both when conditions exist that result in a material deviation from the criteria against which the subject matter was evaluated during an examination. Answer (b) is correct because in such circumstances the conclusion should be directly upon the subject matter. Answer (a) is incorrect because it suggests that the conclusion may be upon the written assertion. Answer (c) is incorrect because it states that the conclusion may not be upon the subject matter and may be upon the written assertion. Answer (d) is incorrect because it states that the conclusion may not be upon the subject matter.

118. (a) The requirement is to determine the element that is **least** likely to be present when a practitioner performs an attest engagement. Answer (a) is correct because while an assertion is generally present, it is from the responsible party, not from the practitioner. Answer (b) is incorrect because ordinarily

there is a responsible party. Answers (c) and (d) are incorrect because both subject matter, and suitable criteria are required.

119. (a) The requirement is to determine whether suitable criteria in an attestation engagement may be available publicly, and/or in the CPA's report. Answer (a) is correct because suitable criteria may be available publicly in the CPA's report, included with the subject matter or in the assertion, well understood by users (e.g., the distance between A and B is twenty feet) or available only to specified parties. Answers (b), (c), and (d) are all incorrect because they suggest that suitable criteria may not be available publicly, in the CPA's report, or both.

120. (c) The requirement is to identify the information that is **least** likely to be included in an agreed-upon procedures attestation report. Answer (c) is correct because an agreed-upon procedures report provides a summary of procedures performed and findings, not limited assurance. Answer (a) is incorrect because the specified party does not take responsibility for the sufficiency of procedures. Answer (b) is incorrect because the report's use is restricted. Answer (d) is incorrect because a summary of procedures performed is included.

121. (a) The requirement is to identify the type of report that is **most** likely to include a summary of findings rather than assurance. Answer (a) is correct because agreed-upon procedures reports include a summary of findings. Answer (b) is incorrect because a compilation report does not provide a summary of findings. Answer (c) is incorrect because an examination report includes positive assurance and not a summary of findings. Answer (d) is incorrect because a review report includes limited (negative) assurance, not a summary of findings.

122. (c) The requirement is to identify the statement that is **not** correct concerning "specified parties" of an agreed-upon procedures report under either the auditing or attestation standards. Answer (c) is correct because while a practitioner should establish a clear understanding regarding the terms of the engagement, preferably in an engagement letter, no such engagement letter is required. Answers (a) and (b) are incorrect because the specified parties must agree on the procedures to be performed and take responsibility for their adequacy. Answer (d) is incorrect because an additional party may be added as a specified party after completion of the engagement.

123. (a) The requirement is to determine the information to be included in a separate paragraph included in an accountant's report on the examination of projected financial statements. Answer (a) is correct because AT 301 requires that such a report include a separate paragraph that describes the limitations on the usefulness of the presentation. See AT 301 for information that should be included in an examination report of prospective financial statements. Answer (b) is incorrect because the report includes no such statement attempting to distinguish between an examination and an audit. Answer (c) is incorrect because the report includes no such disclosure and because the accountant is **not** responsible for events and circumstances up to one year after the report's date. Answer (d) is incorrect because the report suggests that the assumptions do provide a reasonable basis.

124. (a) The requirement is to identify the circumstance in which an accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements. Answer (a) is correct because AT 301 states that an accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that (1) the specified parties involved have participated in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed, (2) use of the report is to be restricted to specified parties involved, and (3) the prospective financial statements include a summary of significant assumptions. Answer (b) is incorrect because the prospective financial statements need not be examined. Answer (c) is incorrect because responsibility for the adequacy of the procedures is taken by the specified parties. Answer (d) is incorrect because a summary of findings may be provided based on the agreed-upon procedures.

125. (c) The requirement is to identify the statement which should be included in an accountant's compilation report on financial forecasts. Answer (c) is correct because when the accountant is preparing a standard compilation report on prospective financial statements, AT 301 requires that the accountant include a statement indicating that the prospective results may not be achieved.

126. (c) The requirement is to identify the appropriate distribution of an entity's financial projection. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation in response to a question such as "What would happen if...?" It is based on a responsible party's assumptions reflecting conditions it expects would exist and the course of action it expects would be taken, given one or more hypothetical assumptions. Projections are "limited use" financial statements meant for the responsible party (generally management) and third parties with whom the responsible party is negotiating directly. Answer (c) is correct because a bank might be expected to receive such a projection. Answers (a), (b), and (d) are all incorrect because projections are meant for "limited use" and not to be broadly distributed to groups such as all employees or potential or current stockholders. AT 301 provides overall guidance on the area of financial forecasts and projections.

127. (c) The requirement is to determine whether either testifying as an expert witness, compiling a financial projection, or both are engagements governed by the provisions of the Statement on Standards for Attestation Statements. Answer (c) is correct because the attestation standards explicitly exclude expert witness work, but include the compilation of a financial projection; note that in most areas compilations are not included in attestation standard coverage, but in the area of prospective financial statement (forecasts as well as projections) coverage is included. Answer (a) is incorrect because it states that expert witness work is included. Answer (b) is incorrect both because it states that expert witness work is included and that compiling a projection is not included. Answer (d) is incorrect because it states that compilations of projections are not included.

128. (a) The requirement is to identify the statement that should be included in a compilation report on a financial

forecast. Answer (a) is correct because the report should state that the compilation does **not** include evaluation of the support of the assumptions underlying the forecast. Answer (b) is incorrect because no such statement is included in a compilation report, and because hypothetical assumptions pertain to financial projections, not financial forecasts. Answer (c) is incorrect because the report makes no statement concerning the range of assumptions. Answer (d) is incorrect because the statement is not included in the report, and because the prospective statements are management's, not the accountant's, representation.

129. (d) The requirement is to identify the type of general use prospective financial statement on which the accountant may appropriately report. Answer (d) is correct because financial forecasts are considered prospective financial statements, and they are appropriate for general use. Answer (a) is incorrect because financial projections are only appropriate for the party responsible for preparing them or for third parties with whom the responsible party is negotiating directly. Answers (b) and (c) are incorrect because partial presentations and pro forma financial statements are not considered prospective financial statements.

130. (d) The requirement is to identify the statement that is **not** included in a compilation report on prospective financial statements. Answer (d) is correct because distribution of such a report is not necessarily restricted to specified parties. Answers (a), (b), and (c) are all incorrect because such statements are included in a compilation report.

131. (d) The requirement is to determine the appropriate type of audit report to be issued when an accountant examines a financial forecast that fails to disclose several significant assumptions used to prepare the forecast. AT 301 states that an adverse opinion is appropriate when significant assumptions are not disclosed.

132. (d) The requirement is to identify what is included in the examination of a financial forecast. Answer (d) is correct because an examination of a forecast includes an evaluation of its preparation and the support underlying management's assumptions. As discussed in AT 301, an examination also includes evaluating the representation of the prospective financial statements for conformity with AICPA presentation guidelines and the issuance of an examination report. Answer (a) is incorrect because the service need not include the compiling or assembling of the financial forecast. Answer (b) is incorrect because distribution of financial forecasts need not be limited. Answer (c) is incorrect because the CPA assumes no responsibility to update management on key events. See AT 301 for information on prospective financial information.

133. (b) The requirement is to identify the type of prospective financial statement that includes one or more hypothetical ("what if?") assumptions. Answer (b) is correct because financial projections include one or more hypothetical assumptions. Answer (a) is incorrect because pro forma financial presentations are designed to demonstrate the effect of a future or hypothetical transaction by showing how it might have affected the historical financial statements if it had been consummated during the period covered by those

statements. Answer (c) is incorrect because partial presentations are presentations that do not meet the minimum presentation guidelines of AT 301. Answer (d) is incorrect because financial forecasts present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and changes in financial information.

134. (d) The requirement is to determine the statement that should be included in an accountant's report on a review of pro forma financial information. Answer (d) is correct because the report must include a reference to the financial statements from which the historical financial information is derived and a statement as to whether such financial statements were audited or reviewed.

135. (b) The requirement is to determine the reply that is **not** an objective of a CPA's examination of a client's MD&A. Answer (b) is correct because an examination of a client's MD&A does not directly address overall conformity with such rules and regulations. Answers (a), (c), and (d) are the three objectives of an MD&A examination agreement.

136. (c) The requirement is to identify an assertion embodied in MD&A. Answer (c) is correct because the attestation standards on MD&A indicate that consistency with the financial statements is an assertion—in addition, occurrence, completeness, and presentation and disclosure are embodied assertions. Answers (a), (b), and (d) are all incorrect because valuation, reliability, and rights and obligations are not considered to be assertions embodied in the MD&A.

137. (b) Answer (b) is correct because the MD&A review of an issuer (public) entity should be restricted to the use of specified parties. Answer (a) is incorrect because a review consists principally of applying analytical procedures, rather than also including search and verification procedures. Answer (c) is incorrect because a consideration of relevant portion of internal control is necessary to identify types of potential misstatements and to select the inquiries and analytical procedures. Answer (d) is incorrect because a review report ordinarily provides negative assurance, not a summary of findings.

138. (b) The requirement is to identify the standards under which Trust Services engagements are performed. Answer (b) is correct because the Statements on Standards for Attestation engagements address such engagements. More information on Trust Services engagements (WebTrust and SysTrust) is available on the AICPA's website—www.aicpa.org. Answers (a) and (c) are incorrect because such standards do not exist. Answer (d) is incorrect because Statements on Auditing Standards do not address Trust Services engagements.

139. (d) The requirement is to identify what the WebTrust seal of assurance relates most directly to. Answer (d) is correct because the WebTrust seal is designed to provide assurance on website security, availability, processing integrity, online privacy and confidentiality. Answers (a), (b), and (c) are all incorrect since WebTrust isn't specially aimed at financial statements, health care facilities, or risk assurance procedures.

140. (b) The requirement is to determine the type of opinion or assurance **most** likely to be included in a CPA's report relating to WebTrust engagements. Answer (b) is correct because the

WebTrust examination report provides an opinion on whether the site meets the Trust Services criteria for one or more of the Trust Services Principles. Answer (a) is incorrect because no opinion on being “hackproof” is issued. Answer (c) is incorrect because negative assurance is not provided. Answer (d) is incorrect because an agreed-upon procedures engagement, not an examination engagement results in a summary of findings.

141. (b) The requirement is to identify the type of engagement that considers security, availability, processing integrity, online privacy and/or confidentiality over any type of defined electronic system. Answer (b) is correct because SysTrust engagements consider any type of defined electronic system. Answer (a) is incorrect because an engagement to consider internal control over financial reporting does not directly address these attributes. Answer (c) is incorrect because there is no such engagement as a website Associate. Answer (d) is incorrect because WebTrust deals more directly with company websites.

142. (b) The requirement is to identify the **most** likely report when a client refuses to provide a written assertion in a Trust Services engagement. Answer (b) is correct because this represents a scope limitation, and client imposed scope limitations are most likely to result in a disclaimer of opinion. Answer (a) is incorrect because an adverse opinion is appropriate when a CPA believes that the information is so misstated as to be misleading. Answer (c) is incorrect because client imposed scope limitations generally result in disclaimers, not qualified opinions. Answer (d) is incorrect because an unmodified opinion is most likely not appropriate in such a circumstance.

143. (a) The requirement is to identify the information provided in a service auditor’s report which includes an opinion on a description of controls implemented. Answer (a) is correct since such a report includes a description of the scope and nature of the CPA’s procedures. Answers (b), (c), and (d) are all incorrect because they suggest information not included in such a report. See AU-C 402 for information on the audit of service organizations.

144. (a) The requirement is to identify a CPA’s reporting responsibility when reporting on internal control implemented for a service organization that processes payroll transactions. Answer (a) is correct because since the CPA is only expressing an opinion on whether controls have been implemented, a disclaimer should be provided on operating effectiveness. Answer (b) is incorrect because no specific statement is made with respect to earlier objectives. Answer (c) is incorrect because controls relevant to financial statement assertions are not so identified. Answer (d) is incorrect because the assessed level of control risk is not disclosed. See AU-C 402 for information on processing of transactions by service organizations.

145. (a) The requirement is to determine whether an auditor who audits the processing of transactions by a service organization may issue a report on either, or both, of whether controls have been implemented and control operating effectiveness. Answer (a) is correct because AU-C 402 indicates that such “service auditors” may issue either of the two types of reports.

146. (a) The requirement is to identify the proper information to be included in a service auditor’s report on whether a client’s controls have been implemented. Answer (a)

is correct because such a report should include a description of the scope and nature of the client’s procedures.

147. (d) The requirement is to determine the propriety of a computer “user” auditor (Lake) making reference to a service auditor’s (Cope) report. Answer (d) is correct because the user auditor should not make reference to the report of the service auditor. See AU-C 402 for reports on the processing of transactions by service organizations.

148. (d) The requirement is to identify the item that is true about SOC 2 reports. Answer (d) is correct as such reports are meant for management of service organizations, user entities and certain other specified entities. Answer (a) is incorrect because it is SOC 1 reports that are meant primarily to assist financial statement auditors. Answer (b) is incorrect because the reports are not meant to be generally available. Answer (c) is incorrect because they relate more directly to the SysTrust principles than they do to internal control over financial reporting.

149. (c) Answer (c) is correct because an SOC 3 report is a general-use report. Answers (a) and (b) are incorrect because SOC 1 and SOC 2 reports are restricted-use reports. Answer (d) is incorrect because no SOC 4 report exists.

150. (a) The requirement is to identify the type of service organization control report **most** likely to result in a restricted use report on security, availability, processing integrity, confidentiality, and/or privacy. Answer (a) is correct as an SOC 2 report is restricted and on such content. Answers (b), (c) and (d) are all incorrect because no such reports exist. The AICPA has issued three service organizations control reports:

- SOC 1: Restricted use reports on controls at a service organization relevant to a user entity’s internal control over financial reporting.
- SOC 2: Restricted use reports on controls at a service organization related to security, availability, processing integrity, confidentiality, and/or privacy.
- SOC 3: General use SysTrust reports related to security, availability, processing integrity, confidentiality, and/or privacy.

151. (b) The requirement is to identify the type of companies to which the internal control provisions of the Sarbanes-Oxley Act of 2002 apply. Answer (b) is correct because the provisions apply to public companies that are registered with the Securities and Exchange Commission. Answer (a) is incorrect because nonissuer companies are not directly affected by the control provisions. Answer (c) is incorrect; there is no \$100,000,000 requirement. Answer (d) is incorrect because nonissuer companies are not directly affected by the internal control provisions of the Act.

152. (a) The requirement is to identify the **most** likely framework to be used by management in its internal control assessment. Answer (a) is correct as the COSO internal control framework (either the original, or the 2013 revision) is by far the most frequently used one. Answer (b) is incorrect because while a COSO enterprise risk management framework does exist, it is not ordinarily used by management in its internal control assessment. Answers (c) and (d) are incorrect because there is no such thing as a “FASB 37 internal control definitional framework” or an “AICPA internal control analysis manager.”

153. (a) The requirement is to identify the statement that **best** describes a CPA's engagement to report on an entity's internal control over financial reporting. Answer (a) is correct because the objective of such engagement is to form an opinion on the effectiveness of internal control. Answer (b) is incorrect because no such negative assurance is provided based on an "audit" of the entity's internal control. Answer (c) is incorrect because such engagements do not project expected benefits of the entity's internal control. Answer (d) is incorrect because such engagements are attestation engagements, not consulting engagements.

154. (c) The requirement is to determine the correct statement regarding an engagement to examine internal control. Answer (c) is correct because the procedures relating to internal control will be more extensive when reporting on internal control as compared to procedures performed for a financial statement audit. This difference occurs because during financial statement audits the auditor may decide not to perform tests of controls and may simply assess control risk at the maximum level. Conversely, in an engagement to report on internal control an auditor must perform additional tests of controls. Answer (a) is incorrect because such duplication of procedures may not be necessary. Answer (b) is incorrect because a report on internal control will not in general increase the reliability of the financial statements. Answer (d) is incorrect because, as indicated, the scope of procedures relating to internal control is more extensive, not more limited, than the assessment of control risk made during a financial statement audit.

155. (c) The requirement is to identify the correct statement concerning the level of assistance that auditors may provide in assisting management with its assessment of internal control. Answer (c) is correct since only limited assistance may be provided so as not to create a situation in which the auditors are auditing their own work. Answer (a) is incorrect since some assistance may be provided. Answer (b) is incorrect because there are limitations on the level of assistance. Answer (d) is incorrect because the tie between risk and assistance seems inappropriate and in the wrong direction; also, this type of tradeoff between risk and assistance is not included in PCAOB auditing standards.

156. (d) The requirement is to identify which of the following need **not** be included in management's report on internal control under Section 404a of the Sarbanes-Oxley Act of 2002. Answer (d) is correct because, while the report must indicate that it is management's responsibility to establish and maintain adequate internal control, it need not also indicate that such control has no significant deficiencies. Answers (a), (b), and (c) are all incorrect because they include information that must be contained in management's report.

157. (a) Answer (a) is correct because all material weaknesses are control deficiencies. Answer (b) is incorrect because a significant deficiency may or may not be a material weakness. Answer (c) is incorrect because not all control deficiencies are material weaknesses. Answer (d) is incorrect because only significant deficiencies and material weaknesses must be communicated.

158. (d) The requirement is to identify the term that is defined as a weakness in internal control that is less severe than a material weakness but important enough to warrant attention by those responsible for oversight of the financial reporting

function. Answer (d) is correct because this is the definition of a significant deficiency. Answer (a) is incorrect because a *control deficiency* exists when the design or operation of a control does not allow management, or employees, in the normal course of performing their functions to prevent or detect misstatements on a timely basis. Answer (b) is incorrect because an *unusual weakness* is not used in the standards for integrated audits. Answer (c) is incorrect because the term unusual deficiency is not used in the standards for integrated audits.

159. (d) The requirement is to identify the amount involved with a material weakness. Answer (d) is correct because a material amount is involved. Answers (a), (b), and (c) are all incorrect because they suggest smaller amounts.

160. (d) The requirement is to identify the minimum likelihood of loss involved in the consideration of a control deficiency. Answer (d) is correct because a control deficiency is a condition in which the operation of a control does not allow management, or employees, in the normal course of performing their functions to prevent or detect misstatements on a timely basis—it does not explicitly consider likelihood of loss. Answer (a) is incorrect because the minimum likelihood of loss is not considered. Answer (b) is incorrect because the control deficiency occurrence of loss need not be more than remote. Answer (c) is incorrect because whether the minimum likelihood of loss is probable is not considered.

161. (a) The requirement is to identify the type of control that reconciliation of cash accounts represents. Answer (a) is correct in that it is a compensating control which supplements a basic underlying control, in this case basic information processing controls related to cash. Answer (b) is incorrect because a preventive control prevents errors or fraud from occurring. Answer (c) is incorrect because the term "adjustive" control is not ordinarily used. Answer (d) is incorrect because "nonroutine" is ordinarily considered a type of transaction (e.g., the year-end close process), not a type of control.

162. (d) The requirement is to identify the type of transaction that establishing loan loss reserves is. Answer (d) is correct because *estimation transactions* are activities involving management's judgments or assumptions, such as determining the allowance for doubtful accounts, establishing warranty reserves, and assessing assets for impairment. Answer (a) is incorrect because the term substantive transaction is not used in PCAOB standards. Answer (b) is incorrect because routine transactions are those for recurring activities, such as sales, purchases, cash receipts and disbursements, and payroll. Answer (c) is incorrect because nonroutine transactions occur only periodically, such as the taking of physical inventory, calculating depreciation expense, or adjusting for foreign currencies; nonroutine transactions generally are not a part of the routine flow of transactions.

163. (d) The requirement is to identify the relationship between an examination of internal control and obtaining an understanding of internal control and assessing control risk as part of an audit. Answer (d) is correct because, while the scope and purpose differ between the two types of engagements, the procedures followed are similar.

164. (d) The requirement is to identify the procedure that involves tracing a transaction from origination through the company's information systems until it is reflected in the company's financial report. Answer (d) is correct because

this is the approach followed in a walk-through. Answer (a) is incorrect because analytical analysis is a general term that simply suggests a general analysis. Answer (b) is incorrect because a substantive procedure addresses the correctness of a particular financial statement amount or disclosure. Answer (c) is incorrect because a test of a control addresses the operating effectiveness of a control.

165. (b) The requirement is to identify the “as of date” for purposes of an audit of internal control performed under PCAOB standards. Answer (b) is correct because the “as of date” is the last day of the fiscal period; it is this date on which the auditor concludes as to the effectiveness of internal control. Answers (a) and (c) are incorrect because neither the first day of the year nor the last day of the auditor’s fieldwork is the appropriate date on which to evaluate internal control. Answer (d) is incorrect because the “as of date” is a particular date, not an average.

166. (c) The requirement is to identify the correct statement concerning a company that makes purchases both through the Internet and by telephone. Answer (c) is correct because both types of purchases are a part of the purchases process and represent major classes of transactions, as per PCAOB requirements. Answer (a) is incorrect because the purchase types themselves are not control objectives for internal control (control objectives address issues such as the completeness of the recording of sales). Answer (b) is incorrect because purchases are not assertions. Answer (d) is incorrect because purchase transactions may or may not be investigated in extreme detail.

167. (a) The requirement is to identify the circumstance(s) in which walk-throughs provide the auditor with primary evidence. A walk-through involves literally tracing a transaction from its origination through the company’s information systems until it is reflected in the financial reports. Answer (a) is correct because a walk-through provides evidence to (1) confirm the auditor’s understanding of the flow of transactions and the design of controls, (2) evaluate the effectiveness of the design of controls, and (3) to confirm whether controls have been implemented. Answer (b) is incorrect because walk-throughs provide the auditors with primary evidence to confirm whether controls have been implemented. Answer (c) is incorrect because walk-throughs provide primary evidence to evaluate the effectiveness of design in internal control. Answer (d) is incorrect both because walk-throughs provide primary evidence to (1) evaluate the effectiveness of the design of controls and (2) confirm whether the controls have been implemented.

168. (a) The requirement is to identify the **most** likely question to be asked of employee personnel during a walk-through. Answer (a) is correct because a question on whether an employee has ever been asked to override the process is included in the example questions to be asked by the auditor. Answer (b) is incorrect because auditors do not in general ask whether the employee believes he or she is underpaid. Answer (c) is incorrect because a direct question on fraudulent transactions like this, while possible, ordinarily is not suggested. Answer (d) is incorrect because the auditor will not usually ask who trained the person. Note that all four questions might be asked, but only one is among those recommended in Standard 5.

169. (a) The requirement is to identify how large the actual loss identified must be for a control deficiency to possibly be considered a material weakness. Answer (a) is correct because a material weakness is determined by whether there is more than a remote likelihood of a material loss occurring due to the control deficiency; the actual loss identified need not be material. Answer (b) is incorrect because it suggests that a material amount identified will not be considered a material weakness. Answer (c) is incorrect because it states that when the identified amount is immaterial it is never a material weakness. Answer (d) is incorrect because it suggests that when an immaterial or material actual loss is discovered, the situation would not be assessed as a possible material weakness.

170. (c) The requirement is to identify the circumstance that makes an account significant for purposes of a PCAOB audit of internal control. Answer (c) is correct because PCAOB requires only more than a remote likelihood of material misstatement. Answer (a) is incorrect because the standard requires only a remote likelihood and because it is limited to material misstatements. Answer (b) is incorrect because the standard requires more than a remote likelihood, not more than a reasonably possible likelihood. Answer (d) is incorrect because material misstatements are involved, not misstatements that are more than inconsequential.

171. (a) The requirement is to identify the appropriate report when a control deficiency that is more than a significant deficiency is identified. Answer (a) is correct because a control deficiency that is more than a significant deficiency is a material weakness, and because a material weakness leads to an adverse opinion on internal control. Answer (b) is incorrect because qualified opinions are not issued when a material weakness exists. Answer (c) is incorrect because an unqualified opinion is not issued when a material weakness exists. Answer (d) is incorrect because explanatory language added to an unqualified report is not appropriate when a material weakness exists.

172. (a) The requirement is to identify the deficiency that is **most** likely to be considered a material weakness in internal control for purposes of an internal control audit of a public company. Answer (a) is correct because ineffective oversight of financial reporting by the audit committee is among the list of circumstances that the PCAOB suggests are strong indicators of the existence of a material weakness. Restatement of previously issued financial statements as a result of a *change in accounting principles* is ordinarily not considered even a significant deficiency. Answer (c) is incorrect because the reply “inadequate segregation of recordkeeping from accounting” makes no real sense because accounting is involved with recordkeeping. Answer (d) is incorrect because control activity weaknesses often do not represent material weaknesses.

173. (b) The requirement is to identify the most appropriate report when a circumstance-caused scope limitation results in inability to evaluate internal control for a significant account involved in the audit. Answer (b) is correct because the PCAOB requires that either a qualified opinion or a disclaimer is appropriate, and because the disclaimer is not listed as an

option. Answer (a) is incorrect because an adverse opinion is not appropriate. Answer (c) is incorrect because an unqualified opinion with explanatory language is not appropriate when the auditor is unable to evaluate internal control for a significant account. Answer (d) is incorrect because answers (a) and (c) are not appropriate.

174. (c) The requirement is to identify the **most** likely significant deficiency relating to a client's antifraud programs. Answer (c) is correct because an active audit committee, not a passive audit committee is needed. Answer (a) is incorrect because a broad scope of internal audit activities is ordinarily a strength, not a deficiency. Answer (b) is incorrect because a whistle-blower program that encourages anonymous submissions is required. Answer (d) is incorrect because it is not ordinarily necessary to perform criminal background investigations for likely customers.

175. (a) The requirement is to identify the appropriate audit report when a material weakness is corrected subsequent to year-end, but before the audit report is issued. Answer (a) is correct because the PCAOB requires an adverse audit report when a material weakness exists at year-end, the "as of date." Answer (b) is incorrect because an unqualified opinion is not appropriate. Answer (c) is incorrect because an unqualified opinion with explanatory language is not adequate. Answer (d) is incorrect because a qualified opinion is not appropriate when a material weakness exists at year-end.

176. (b) The requirement is to specify whether material weaknesses and/or significant deficiencies lead to an adverse opinion on internal control in an integrated audit. Answer (b) is correct because only material weaknesses lead to an adverse opinion. Answer (a) is incorrect because significant deficiencies do not result in an adverse opinion. Answer (c) is incorrect because material weaknesses do result in adverse opinions but significant deficiencies do not. Answer (d) is incorrect because material weaknesses do result in adverse opinions.

177. (b) The requirement is to specify what types of deficiencies must be communicated by the auditor to the audit committee. Answer (b) is correct because the auditor must communicate material weaknesses and other significant deficiencies, but not all control deficiencies. Answer (a) is incorrect because control deficiencies that are not significant need not be communicated to the audit committee (unless the auditor has made an agreement to communicate them). Answers (c) and (d) are incorrect because known material weaknesses must be communicated to the audit committee and control deficiencies that are not significant deficiencies need not be communicated.

178. (c) The requirement is to determine the manner in which significant deficiencies are communicated by the auditor to the audit committee under PCAOB requirements. Answer (c) is correct because the PCAOB requires a written communication. Answer (a) is incorrect because a written communication is required. Answer (b) is incorrect because the communication must be in a written form, not in an oral form. Answer (d) is incorrect because both material weaknesses and significant deficiencies must be communicated.

179. (c) The requirement is to identify the correct statement concerning the external auditors' use of the work of others when performing an audit of internal control of a public company. Answer (c) is correct because, after assuring themselves as to the competence and objectivity of the internal auditors and others, the external auditors may use their work—particularly in low-risk areas and when that work is supervised and/or reviewed. Answer (a) is incorrect because using the work of internal auditors and others is allowed. Answer (b) is incorrect because there is no such requirement of reporting to the audit committee, although this is one indication of internal auditor objective. Answer (d) is incorrect because there are limitations, and because it is uncertain whether liability will be shared.

180. (c) The requirement is to identify the information that must be communicated in writing to management. Answer (c) is correct because in an integrated audit all material weaknesses, significant deficiencies, and other control deficiencies must be reported to management. Answers (a) and (b) are incorrect because they are incomplete. Answer (d) is incorrect because "all suspected and possible employee law violations" need not be communicated.

181. (a) The requirement is to identify a correct statement about applying a top-down approach to identify controls to test in an integrated audit. Answer (a) is correct because certain effective entity-level controls may allow the auditor to omit additional testing beyond those controls. Answer (b) is incorrect because starting with assertions does not represent starting at the top (starting at the top includes consideration of the financial statements and entity-level controls first). Answer (c) is incorrect because consideration of entity-level controls cannot be avoided. Answer (d) is incorrect because not all controls related to assertions need to be focused upon, and because one may not omit controls related to the financial statements.

182. (d) The requirement is to identify the statement **not** included in a standard unqualified opinion on internal control performed under PCAOB requirements. Answer (d) is correct because the report indicates that management is responsible for maintaining effective internal control over financial reporting, not management and the audit committee. Answers (a), (b) and (c) are all incorrect because they represent statements included in the audit report.

183. (d) The requirement is to identify the statement that should be included in a CPA's report on a client's internal control over financial reporting. Answer (d) is correct because AT 501 requires that the report include a comment on the inherent limitations of any internal control.

184. (b) The requirement is to describe the contents of a report on the study of internal control that is based on criteria established by governmental agencies. Answer (b) is correct because the report should indicate matters covered by the consideration and whether the auditor's consideration included tests of controls with the procedures covered by his/her consideration. Additionally, the report should describe the objectives and limitations of internal control and the accountant's evaluation thereof; state the accountant's conclusion, based on the agency's criteria; and describe the

purpose of the report and state that it should not be used for any other purpose. Answer (a) is incorrect because the agency's name should be included. Answer (c) is incorrect because a conclusion may be made relative to the agency's criteria. Answer (d) is incorrect because the accountant should not assume responsibility for the comprehensiveness of the criteria.

185. (b) AT 501 states that when a deviation from the control criteria being reported upon exists (here a material weakness in internal control) the CPA should report directly upon the subject matter and not upon the assertion.

186. (c) The requirement is to identify the type of association **not** permitted under the compliance attestation standards. AT 601 does not allow the CPA to perform a review over compliance.

187. (b) The requirement is to identify the information provided in an agreed-upon procedures report on compliance with contractual requirements to pay royalties. Answer (b) is correct because agreed-upon procedures reports include a list of the procedures performed (or reference thereto) and findings. Answer (a) is incorrect because no such disclaimer of opinion is provided in an agreed-upon procedures report. Answer (c) is incorrect because no opinion is included in an agreed-upon procedures report. Answer (d) is incorrect because an agreed-upon procedures report includes a statement disclaiming an opinion on the sufficiency of procedures, not an acknowledgement of the sufficiency of the procedures. See AT 201 for guidance on agreed-upon procedures engagements.

188. (a) The requirement is to identify the statement that is included in a CPA's report on agreed-upon procedures on management's assertion about an entity's compliance with specified requirements. Answer (a) is correct because such an agreed-upon procedures report includes a statement of limitations on the use of the report because it is intended solely for the use of specified parties. See AT 601 for information that should be included in such an agreed-upon procedures report. Answer (b) is incorrect because no "opinion" is included. Answer (c) is incorrect because a summary of findings, not negative assurance is provided. Answer (d) is incorrect because the CPA makes no representation regarding the sufficiency of procedures.

189. (c) The requirement is to identify the correct statement concerning an examination report when management has properly disclosed an instance of material noncompliance. AT 601 states that the opinion should be qualified or adverse. Note that AT 601 requires the CPA's report to relate directly to the subject matter when the opinion is modified.

190. (b) The requirement is to determine an auditor's responsibility when auditing a not-for-profit entity that receives governmental financial assistance. Answer (b) is correct because AU-C 806 requires that the auditor assess whether management has identified laws and regulations that have a direct and material effect on the entity's financial statements; AU-C 806 also presents procedures to be followed in assessing such laws and regulations. Answer (a) is incorrect because such a separate report describing expected benefits and costs does not need to be issued. Answer (c) is incorrect because the CPA will not notify the governmental agency that the audit is not designed to provide assurance. Answer (d)

is incorrect because the CPA does not express an opinion on the entity's continued eligibility for governmental financial assistance. AU-C 806 presents requirements relating to compliance auditing for governmental entities and recipients of governmental financial assistance.

191. (c) The requirement is to determine the focus of an auditor's attention in detecting misstatements resulting from violations of laws and regulations when auditing a not-for-profit organization that receives financial assistance from governmental agencies. Answer (c) is correct because the focus of such procedures should be on violations that have a direct and material effect on the amounts in the organization's financial statements (AU-C 806). Answers (a), (b), and (d) all represent a focus that is not as accurate as that provided in answer (c).

192. (b) The requirement is to determine the proper scope of a governmental audit. The General Accounting Office's "Yellow Book" suggests that in addition to financial statements, such an audit may include consideration of (1) program results, (2) compliance with laws and regulations, and (3) economy and efficiency.

193. (b) The requirement is to identify whether an auditor performing an audit in accordance with Government Auditing Standards (the "Yellow Book") is required to report on noteworthy accomplishments of the program, the scope of the auditor's testing of internal controls, or both. Answer (b) is correct because the "Yellow Book" requires reporting only upon the scope of the auditor's testing of internal controls. Answers (a), (c), and (d) all include an incorrect combination of reporting replies.

194. (b) The requirement is to identify whether an auditor performing an audit in accordance with Government Auditing Standards (the "Yellow Book") is required to report on recommendations for actions to improve operations, the scope of tests of compliance with laws and regulations, or both. Answer (b) is correct because the "Yellow Book" requires reporting upon the scope of the auditor's tests of compliance with laws and regulations. Answers (a), (c), and (d) all include an incorrect combination of reporting replies.

195. (a) The requirement is to identify the correct statement with respect to a financial statement audit conducted in accordance with Government Auditing Standards (the "Yellow Book"). Answer (a) is correct because the auditor issues a report on compliance with laws and internal control, and a report on the financial information. Answer (b) is incorrect because a financial statement audit does not address economy and efficiency in the manner suggested. Answer (c) is incorrect because recommendations for actions to correct problems and improve operations are not ordinarily included. Answer (d) is incorrect because a financial statement audit does not address whether programs are achieving the desired results.

196. (a) The requirement is to identify the correct statement with respect to a financial statement audit conducted in accordance with Government Auditing Standards (the "Yellow Book"). Answer (a) is correct because the auditor issues a report on compliance with laws and internal control, and a report on the financial information. Answer (b) is incorrect because not all instances of abuse, waste and mismanagement

are so reported. Answer (c) is incorrect because the views of officials are not reported. Answer (d) is incorrect because internal control activities designed to detect or prevent fraud are not reported to the inspector general.

197. (d) The requirement is to identify the circumstance in which an auditor is required to report a falsification of accounting records directly to a federal inspector general. Answer (d) is correct because under Government Auditing Standards a falsification of accounting records must ordinarily be communicated by the auditor to the auditee and, if the auditee fails to make appropriate disclosure, by the auditor to a federal inspector general. Answers (a), (b), and (c) all provide inaccurate descriptions of auditor reporting responsibility. See Government Auditing Standards (the “Yellow Book”) for information on reporting under Government Auditing Standards.

198. (a) The requirement is to identify a common aspect of various types of audits of recipients of federal financial assistance in accordance with federal audit regulations. Answer (a) is correct because audits of recipients of federal financial assistance include reports on (1) the financial statements, and (2) a separate or combined report on internal control and on compliance with laws and regulations. Answer (b) is incorrect because materiality levels are not ordinarily lower or always determined by the governmental entity. Answer (c) is incorrect because the auditor need not obtain such written management representations. Answer (d) is incorrect because requirements for reporting illegal acts may vary depending upon the type of audit being performed. AU-C 806 provides requirements related to auditing entities that have received governmental financial assistance. In addition, guidance is provided by Government Auditing Standards (GAS), also referred to as the “Yellow Book,” published by the Comptroller General of the United States.

199. (b) The requirement is to identify to whom an auditor **most** likely would be responsible for communicating significant deficiencies in the design of internal control. Answer (b) is correct because in audits under Government Auditing Standards, significant deficiencies in the design of internal control are communicated to legislative and regulatory bodies (AU-C 806). Answer (a) is incorrect because the Securities and Exchange Commission does not ordinarily receive information on such deficiencies. Answer (c) is incorrect because while a court-appointed creditors’ committee might in some circumstances receive information on such deficiencies, this practice is not as frequent as is done under Government Auditing Standards. Answer (d) is incorrect because shareholders do not normally receive reports on significant deficiencies or material weaknesses (see AU-C 265).

200. (c) The requirement is to determine the opinion which an auditor should express in a report on compliance when s/he has detected material instances of noncompliance within the program. AU-C 806 defines these instances of material noncompliance as failures to follow requirements, or violations of regulations or grants which cause the auditor to conclude that the total of the misstatements resulting from these failures or violations is material to the financial statements. Therefore, answer (c) is correct because the auditor should issue a qualified or an adverse opinion. Answer (a) is incorrect because the auditor is required under Governmental Auditing Standards to provide reasonable assurance on the

entity’s compliance with the applicable laws and regulations. Answer (b) is incorrect because the auditor must disclose the instances of noncompliance. Answer (d) is incorrect because the auditor should not disclaim an opinion as a result of noncompliance.

201. (b) The requirement is to determine a documentation requirement that an auditor should follow when auditing in accordance with (also referred to as the “Yellow Book”). Answer (b) is correct because Government Auditing Standards require documentation of supervisory review before the report is issued.

202. (a) The requirement is to identify the statement that should be included in an auditor’s report on an entity’s compliance with laws and regulations when performing an audit in accordance with Government Auditing Standards. Answer (a) is correct because such compliance reports require a statement that management is responsible for compliance with laws, regulations, contracts, and grants. See AU-C 806 for this requirement and others.

203. (b) The requirement is to determine when an auditor reporting under would **most** likely be required to communicate management’s misappropriation of assets directly to a federal inspector general. Answer (b) is correct because Government Auditing Standards requires that when a governing body fails to make a required report on such acts the auditors should communicate the matter to the external body specified in the law or regulation. Answer (a) is incorrect because such concealment will not necessarily lead to communication to a federal inspector general. Answer (c) is incorrect because material misstatement does not necessarily lead to such communication. Answer (d) is incorrect because the expected duration of the scheme is not what leads to reporting to a federal inspector general.

204. (b) The requirement is to identify the auditor’s proper measure of materiality for major federal financial assistance programs under the Single Audit Act. AU-C 806 requires that it be determined separately for each major program.

205. (b) The requirement is to identify the appropriate compliance report under the Single Audit Act when a CPA has detected noncompliance with requirements that have a material effect on that program. AU-C 806 states that under such circumstances the auditor should express a qualified or adverse opinion.

206. (c) The requirement is to identify the source of authoritative guidance for performing audits of a city that is subject to the requirements of the Uniform Single Audit Act of 1984. Answer (c) is correct because while the AICPA’s generally accepted auditing standards must be followed to the extent they are pertinent, the General Accounting Office Government Auditing Standards must also be adhered to. The other replies all relate to standards not directly related to the Uniform Single Audit Act.

207. (c) The requirement is to identify the correct statement which would communicate weaknesses in internal control used in administering a federal financial assistance program when a CPA has examined the general purpose financial statements of a municipality. The AICPA Accounting and Audit Guide, Audits of State and Local Governmental Units, requires the communication of weaknesses that are material in relation to the federal financial assistance program.

Multiple-Choice Questions (1–59)

Preparation, Compilation, and Review—General

1. Statements on Standards for Accounting and Review Services establish standards and procedures for which of the following engagements?

- a. Assisting in adjusting the books of account for a partnership.
- b. Reviewing interim financial data required to be filed with the SEC.
- c. Processing financial data for clients of other accounting firms.
- d. **Compiling an individual's personal financial statement to be used to obtain a mortgage.**

2. The authoritative body designated to promulgate standards concerning an accountant's association with unaudited financial statements of an entity that is **not** required to file financial statements with an agency regulating the issuance of the entity's securities is the

- a. Financial Accounting Standards Board.
- b. General Accounting Office.
- c. **Accounting and Review Services Committee.**
- d. Auditing Standards Board.

3. Which of the following accounting services may an accountant perform without being required to issue a compilation or review report under the Statements on Standards for Accounting and Review Services?

- I. Preparing a working trial balance.
 - II. Preparing standard monthly journal entries.
- a. I only.
 - b. II only.
 - c. **Both I and II.**
 - d. Neither I nor II.

4. May an accountant accept an engagement to compile or review the financial statements of a not-for-profit entity if the accountant is unfamiliar with the specialized industry accounting principles, but plans to obtain the required level of knowledge before compiling or reviewing the financial statements?

	Compilation	Review
a.	No	No
b.	Yes	No
c.	No	Yes
d.	Yes	Yes

5. Which of the following statements is correct concerning both an engagement to compile and an engagement to review a nonissuer's financial statements?

- a. **The accountant does not contemplate obtaining an understanding of internal control.**

- b. The accountant must be independent in fact and appearance.
- c. The accountant expresses no assurance on the financial statements.
- d. The accountant should obtain a written management representation letter.

6. The objective of an accountant's compilation of the financial statements of a nonissuer (nonpublic company) is to provide what type of assurance?

- a. Absolute assurance.
- b. Limited assurance.
- c. **No assurance.**
- d. Reasonable assurance.

7. A company hires a CPA who has invested in its outstanding bonds payable to issue accounting reports for the company. Assuming any required disclosures are made, which of the following reports may the CPA issue?

- a. **Compilations.**
- b. Reviews.
- c. Audits.
- d. Agreed-upon procedures.

8. Independence is required in which of the following types of financial statement engagements?

	Review	Compilation	Preparation
a.	No	No	No
b.	No	Yes	Yes
c.	Yes	No	No
d.	Yes	Yes	Yes

9. Ordinarily, an accountant's report is issued for which of the following engagements?

	Preparation	Compilation
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

10. Under the Statements on Standards for Accounting and Review Services (SSARS), an engagement letter or other suitable form of written agreement is required for:

	Financial Statement Preparation	Financial Statement Compilation
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

11. Under the Statements on Standards for Accounting and Review services, a representations letter (“written representations”), signed by management, is required for:

	Financial Statement Preparation	Financial Statement Compilation
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

Preparation

12. Which of the following is correct relating to an accountant’s engagement to prepare a client’s financial statements?

- a. A report is issued with only limited assurance that the financial statements follow the applicable financial reporting framework.
- b. A representation letter, signed by a majority of the board of directors is required.
- c. An engagement letter signed by both management and the accountant should be obtained.
- d. Inquiry and analytical procedures are the only required procedures.

13. Which of the following is **not** correct relating to an accountant’s engagement to prepare a client’s financial statements?

- a. The accountant should obtain an understanding of the client’s financial reporting framework.
- b. The accountant should not assist the client in making significant judgments relating to particular financial statement accounts.
- c. Ordinarily, prepared financial statements include indication on each page that no CPA provides any assurance on the financial statements.
- d. Documentation requirements include a written engagement letter.

14. Statements on Standards for Accounting and Review Services (SSARS) apply when an accountant has

- a. Typed client-prepared financial statements, without modification, as an accommodation to the client.
- b. Provided a client with a financial statement format that does **not** include dollar amounts, to be used by the client in preparing financial statements.
- c. Proposed correcting journal entries to be recorded by the client that change client-prepared financial statements.
- d. Generated, through the use of computer software, financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP.

15. For which of the following services do the Statements on Standards for Accounting and Review Services apply?

- a. Preparation of financial statement with a tax return solely for submission to taxing authorities.

- b. Entering general ledger transactions or processing payments (general bookkeeping) in an accounting software system.
- c. Preparing financial statements in conjunction with litigation services that involve ending or potential legal or regulatory proceedings.
- d. Preparation of personal financial statements for presentation alongside a financial plan.

16. Documentation of a financial statement preparation engagement performed under SSARS is **least** likely to include:

- a. Copy of the financial statements.
- b. Engagement letter.
- c. Internal control assessment.
- d. Significant professional judgments made throughout the engagement.

17. A client has engaged a CPA to prepare its historical financial statements under the SSARS, but does not wish for those statements to include typical note disclosures. When the CPA believes there is no intention to mislead users of the financial statements, the CPA should:

- a. Prepare the financial statements as requested, with no disclosure of the omission of the notes.
- b. Prepare the financial statements and disclose the omission of the notes on the face of the financial statements or in a note to the financial statements.
- c. Modify the preparation report to describe in detail this departure from GAAP.
- d. Not accept such an engagement.

18. Financial statements prepared by an accountant include the statement “no assurance is provided” on each page. Which of the following is correct concerning accountant reporting on such financial statements prepared by an accountant under SSARS?

- a. An accountant’s report with no assurance should be issued.
- b. An accountant’s report describing the departure from GAAP should be issued.
- c. A compilation report is required.
- d. Ordinarily, no accountant’s report need be issued.

Compilation—General

19. An accountant is required to comply with the provisions of Statements on Standards for Accounting and Review Services when

- I. Reproducing client-prepared financial statements, without modification, as an accommodation to a client.
 - II. Preparing standard monthly journal entries for depreciation and expiration of prepaid expenses.
- a. I only.
 - b. II only.
 - c. Both I and II.
 - d. Neither I nor II.

20. Davis, CPA, accepted an engagement to audit the financial statements of Tech Resources, a nonissuer. Before the completion of the audit, Tech requested Davis to change the engagement to

a compilation of financial statements. Before Davis agrees to change the engagement, Davis is required to consider the

	Additional audit effort necessary to complete the audit	Reason given for Tech's request
a.	No	No
b.	Yes	Yes
c.	Yes	No
d.	No	Yes

21. An accountant may compile a nonissuer's financial statements that omit all of the disclosures required by GAAP only if the omission is

- I. Clearly indicated in the accountant's report.
 - II. Not undertaken with the intention of misleading the financial statement users.
- a. I only.
 - b. II only.
 - c. Both I and II.**
 - d. Either I or II.

Compilation Procedures

22. When engaged to compile the financial statements of a nonissuer (nonpublic) entity, an accountant is required to possess a level of knowledge of the entity's accounting principles and practices. This requirement **most** likely will include obtaining a general understanding of the

- a. Stated qualifications of the entity's accounting personnel.**
- b. Design of the entity's internal controls placed in operation.
- c. Risk factors relating to misstatements arising from illegal acts.
- d. Internal control awareness of the entity's senior management.

23. Which of the following procedures is ordinarily performed by an accountant in a compilation engagement of a nonissuer (nonpublic) entity?

- a. Reading the financial statements to consider whether they are free of obvious mistakes in the application of accounting principles.**
- b. Obtaining written representations from management indicating that the compiled financial statements will **not** be used to obtain credit.
- c. Making inquiries of management concerning actions taken at meetings of the stockholders and the board of directors.
- d. Applying analytical procedures designed to corroborate management's assertions that are embodied in the financial statement components.

Compilation Reporting

24. While performing a compilation of financial statements, information indicating that the entity whose information is being compiled may lack the ability to continue as a going concern has come to the accountant's attention. The client agrees that such a situation does exist, but refuses to add the disclosures required by GAAP in this situation. What effect is this **most** likely to have on the accountant's review report?

- a. No effect; a standard unmodified report is appropriate.
- b. The report should indicate a departure from generally accepted accounting principles, with addition of an emphasis-of-matter paragraph.**
- c. An adverse opinion should be issued, with modification of the opinion paragraph and addition of an emphasis-of-matter paragraph.
- d. A qualified opinion should be issued, with modification of the opinion paragraph and addition of an emphasis-of-matter paragraph.

25. When compiled financial statements are accompanied by an accountant's report, that report should state that

- a. A compilation includes assessing the accounting principles used and significant management estimates, as well as evaluating the overall financial statement presentation.
- b. The accountant compiled the financial statements in accordance with Statements on Standards for Accounting and Review Services.**
- c. A compilation is substantially less in scope than an audit in accordance with GAAS, the objective of which is the expression of an opinion.
- d. The accountant is not aware of any material modifications that should be made to the financial statements to conform with GAAP.

26. Miller, CPA, is engaged to compile the financial statements of Web Co., a nonissuer (nonpublic) entity, in conformity with the income tax basis of accounting. If Web's financial statements do **not** disclose the basis of accounting used, Miller should

- a. Disclose the basis of accounting in the accountant's compilation report.**
- b. Clearly label each page "Distribution Restricted—Material Modifications Required."
- c. Issue a special report describing the effect of the incomplete presentation.
- d. Withdraw from the engagement and provide **no** further services to Web.

27. When an accountant is engaged to compile a nonissuer's financial statements that omit substantially all disclosures required by GAAP, the accountant should indicate in the compilation report that the financial statements are

- a. Not designed for those who are uninformed about the omitted disclosures.**

- b. Prepared in conformity with a comprehensive basis of accounting other than GAAP.
- c. Not compiled in accordance with Statements on Standards for Accounting and Review Services.
- d. Special-purpose financial statements that are **not** comparable to those of prior periods.

28. Which of the following is **least** likely to be included in the understanding with management that an accountant obtains when a compilation is to be performed?

- a. The objective of a compilation is to assist management in presenting financial information in the form of financial statements.
- b. Management is responsible for preventing and detecting fraud.
- c. Management is responsible for identifying and ensuring that the company complies with laws and regulations applicable to its activities.
- d. In a compilation an accountant obtains only limited assurance of detecting misstatements.

29. Clark, CPA, compiled and properly reported on the financial statements of Green Co., a nonissuer, for the year ended March 31, 20X8. These financial statements omitted substantially all disclosures required by generally accepted accounting principles (GAAP). Green asked Clark to compile the statements for the year ended March 31, 20X9, and to include all GAAP disclosures for the 20X9 statements only, but otherwise present both years' financial statements in comparative form. What is Clark's responsibility concerning the proposed engagement?

- a. Clark may **not** report on the comparative financial statements because the 20X8 statements are **not** comparable to the 20X9 statements that include the GAAP disclosures.
- b. Clark may report on the comparative financial statements provided the 20X9 statements do **not** contain any obvious material misstatements.
- c. Clark may report on the comparative financial statements provided an explanatory paragraph is added to Clark's report on the comparative financial statements.
- d. Clark may report on the comparative financial statements provided Clark updates the report on the 20X8 statements that do **not** include the GAAP disclosures.

30. Which of the following statements should **not** be included in an accountant's standard report based on the compilation of an entity's financial statements?

- a. A statement that the compilation was performed in accordance with standards established by the American Institute of CPAs.
- b. A statement that the accountant has **not** audited or reviewed the financial statements.
- c. A statement that the accountant does **not** express an opinion but expresses only limited assurance on the financial statements.

- d. A statement that a compilation is limited to presenting, in the form of financial statements, information that is the representation of management.

31. How does an accountant make the following representations when issuing the standard report for the compilation of a nonissuer's financial statements?

	The financial statements have not been audited	The accountant has compiled the financial statements
a.	Implicitly	Implicitly
b.	Explicitly	Explicitly
c.	Implicitly	Explicitly
d.	Explicitly	Implicitly

32. An accountant's compilation report should be dated as of the date of

- a. Completion of fieldwork.
- b. Completion of required compilation procedures.
- c. Transmittal of the compilation report.
- d. The latest subsequent event referred to in the notes to the financial statements.

33. An accountant has compiled the financial statements of a nonissuer in accordance with Statements on Standards for Accounting and Review Services (SSARS). Does SSARS require that the compilation report be printed on the accountant's letterhead and that the report be manually signed by the accountant?

	Printed on the accountant's letterhead	Manually signed by the accountant
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

34. Which of the following is correct relating to compiled financial statements?

- a. A compilation report is issued.
- b. Omission of note disclosures is unacceptable.
- c. A written or oral engagement letter is required.
- d. Each page of the financial statements should have a restriction such as "Restricted for Management's Use Only."

35. A compilation report is **not** required when compiled financial statements are expected to be used by

- a. Management only.
- b. Management and third parties.
- c. Third parties only.
- d. A compilation report is required whenever financial statements are compiled.

Review—General

36. If requested to perform a review engagement for a nonissuer in which an accountant has an immaterial direct financial interest, the accountant is

- a. Not independent and, therefore, may not be associated with the financial statements.
- b. Not independent and, therefore, may not issue a review report.
- c. Not independent and, therefore, may issue a review report, but may not issue an auditor's opinion.
- d. Independent because the financial interest is immaterial and, therefore, may issue a review report.

37. Moore, CPA, has been asked to issue a review report on the balance sheet of Dover Co., a nonissuer. Moore will not be reporting on Dover's statements of income, retained earnings, and cash flows. Moore may issue the review report provided the

- a. Balance sheet is presented in a prescribed form of an industry trade association.
- b. Scope of the inquiry and analytical procedures has not been restricted.
- c. Balance sheet is not to be used to obtain credit or distributed to creditors.
- d. Specialized accounting principles and practices of Dover's industry are disclosed.

38. Baker, CPA, was engaged to review the financial statements of Hall Co., a nonissuer. During the engagement Baker uncovered a complex scheme involving client illegal acts that materially affect Hall's financial statements. If Baker believes that modification of the standard review report is **not** adequate to indicate the deficiencies in the financial statements, Baker should

- a. Disclaim an opinion.
- b. Issue an adverse opinion.
- c. Withdraw from the engagement.
- d. Issue a qualified opinion.

Review Procedures

39. Which of the following is **not** generally considered a procedure followed by an accountant in obtaining a reasonable basis for the expression of limited assurance for a review of financial statements?

- a. Apply analytical procedures.
- b. Assess fraud risk.
- c. Make inquiries of management.
- d. Obtain written representations from management.

40. Which of the following procedures would an accountant **least** likely perform during an engagement to review the financial statements of a nonissuer?

- a. Observing the safeguards over access to and use of assets and records.
- b. Comparing the financial statements with anticipated results in budgets and forecasts.
- c. Inquiring of management about actions taken at the board of directors' meetings.

- d. Studying the relationships of financial statement elements expected to conform to predictable patterns.

41. Which of the following procedures should an accountant perform during an engagement to review the financial statements of a nonissuer?

- a. Communicating significant deficiencies discovered during the assessment of control risk.
- b. Obtaining a client representation letter from members of management.
- c. Sending bank confirmation letters to the entity's financial institutions.
- d. Examining cash disbursements in the subsequent period for unrecorded liabilities.

42. An accountant should perform analytical procedures during an engagement to

	Compile a nonissuer's financial statements	Review a nonissuer's financial statements
a.	No	No
b.	Yes	Yes
c.	Yes	No
d.	No	Yes

43. Which of the following inquiry or analytical procedures ordinarily is performed in an engagement to review a nonissuer's financial statements?

- a. Analytical procedures designed to test the accounting records by obtaining corroborating audit evidence.
- b. Inquiries concerning the entity's procedures for recording and summarizing transactions.
- c. Analytical procedures designed to test management's assertions regarding continued existence.
- d. Inquiries of the entity's attorney concerning contingent liabilities.

44. Which of the following procedures would **most** likely be included in a review engagement of a nonissuer?

- a. Preparing a bank transfer schedule.
- b. Inquiring about related-party transactions.
- c. Assessing internal control.
- d. Performing cutoff tests on sales and purchases transactions.

45. Which of the following would the accountant **most** likely investigate during the review of financial statements of a nonissuer if accounts receivable did **not** conform to a predictable pattern during the year?

- a. Sales returns and allowances.
- b. Credit sales.
- c. Sales of consigned goods.
- d. Cash sales.

46. When performing an engagement to review a nonissuer's financial statements, an accountant **most** likely would

- a. Confirm a sample of significant accounts receivable balances.

- b. Ask about actions taken at board of directors' meetings.
- c. Obtain an understanding of internal control.
- d. Limit the distribution of the accountant's report.

Review Reporting

47. A CPA is reporting on comparative financial statements of a nonissuer. The CPA audited the prior year's financial statements and compiled those of the current year in accordance with Statements on Standards for Accounting and Review Services (SSARS). The CPA has added a separate paragraph to the review report to describe the responsibility assumed for the prior year's audited financial statements. This separate paragraph should indicate

- a. The type of opinion expressed previously.
- b. That the CPA did **not** update the assessment of control risk.
- c. The reasons for the change from an audit to a review.
- d. That the audit report should **no** longer be relied on.

48. An accountant has been engaged to review a nonissuer's financial statements that contain several departures from GAAP. If the financial statements are **not** revised and modification of the standard review report is **not** adequate to indicate the deficiencies, the accountant should

- a. Withdraw from the engagement and provide **no** further services concerning these financial statements.
- b. Inform management that the engagement can proceed only if distribution of the accountant's report is restricted to internal use.
- c. Determine the effects of the departures from GAAP and issue a special report on the financial statements.
- d. Issue a modified review report provided the entity agrees that the financial statements will **not** be used to obtain credit.

49. When providing limited assurance that the financial statements of a nonissuer (nonpublic entity) require **no** material modifications to be in accordance with generally accepted accounting principles, the accountant should

- a. Assess the risk that a material misstatement could occur in a financial statement assertion.
- b. Confirm with the entity's lawyer that material loss contingencies are disclosed.
- c. Understand the accounting principles of the industry in which the entity operates.
- d. Develop audit plans to determine whether the entity's financial statements are fairly presented.

50. Smith, CPA, has been asked to issue a review report on the balance sheet of Cone Company, a nonissuer, and not on the other related financial statements. Smith may do so only if

- a. Smith compiles and reports on the related statements of income, retained earnings, and cash flows.
- b. Smith is **not** aware of any material modifications needed for the balance sheet to conform with GAAP.
- c. The scope of Smith's inquiry and analytical procedures is **not** restricted.
- d. Cone is a new client and Smith accepts the engagement after the end of Cone's fiscal year.

51. In reviewing the financial statements of a nonissuer, an accountant is required to modify the standard report for which of the following matters?

	Inability to assess the risk of material misstatement due to fraud	Discovery of significant deficiencies in the design of the entity's internal control
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

52. Each page of a nonissuer's financial statements reviewed by an accountant should include the following reference:

- a. See Accompanying Accountant's Footnotes.
- b. Reviewed, No Material Modifications Required.
- c. See Accountant's Review Report.
- d. No such reference to the report is required.

53. Financial statements of a nonissuer that have been reviewed by an accountant should be accompanied by a report stating that a review

- a. Provides only limited assurance that the financial statements are fairly presented.
- b. Includes examining, on a test basis, information that is the representation of management.
- c. Consists principally of inquiries of company personnel and analytical procedures applied to financial data.
- d. Does **not** contemplate obtaining corroborating evidential matter or applying certain other procedures ordinarily performed during an audit.

54. An accountant who had begun an audit of the financial statements of a nonissuer was asked to change the engagement to a review because of a restriction on the scope of the audit. If there is reasonable justification for the change, the accountant's review report should include reference to the

	Scope limitation that caused the changed engagement	Original engagement that was agreed to
a.	Yes	No
b.	No	Yes
c.	No	No
d.	Yes	Yes

55. Gole, CPA, is engaged to review the 20X8 financial statements of North Co., a nonissuer. Previously, Gole audited North's 20X7 financial statements and expressed an unqualified opinion. Gole decides to include a separate paragraph in the 20X8 review report because North plans to present comparative financial statements for 20X8 and 20X7. This separate paragraph should indicate that

- a. The 20X8 review report is intended solely for the information of management and the board of directors.
- b. The 20X7 auditor's report may **no** longer be relied on.

- c. No auditing procedures were performed after the date of the 20X7 auditor's report.
- d. There are justifiable reasons for changing the level of service from an audit to a review.
- 56.** An accountant's standard report on a review of the financial statements of a nonissuer should state that the accountant
- Does **not** express an opinion or any form of limited assurance on the financial statements.
 - Is **not** aware of any material modifications that should be made to the financial statements for them to conform with GAAP.
 - Obtained reasonable assurance about whether the financial statements are free of material misstatement.
 - Examined evidence, on a test basis, supporting the amounts and disclosures in the financial statements.
- 57.** Financial statements of a nonissuer that have been reviewed by an accountant should be accompanied by a report stating that
- The scope of the inquiry and analytical procedures performed by the accountant has not been restricted.
 - All information included in the financial statements is the representation of the management of the entity.
 - A review includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
- d. A review is greater in scope than a compilation, the objective of which is to present financial statements that are free of material misstatements.
- 58.** During a review of the financial statements of a nonissuer, an accountant becomes aware of a lack of adequate disclosure that is material to the financial statements. If management refuses to correct the financial statement presentations, the accountant should
- Issue an adverse opinion.
 - Issue an "except for" qualified opinion.
 - Disclose this departure from generally accepted accounting principles in a separate paragraph of the report.
 - Express only limited assurance on the financial statement presentations.
- 59.** An accountant who reviews the financial statements of a nonissuer should issue a report stating that a review
- Is substantially less in scope than an audit.
 - Provides negative assurance that internal control is functioning as designed.
 - Provides only limited assurance that the financial statements are fairly presented.
 - Is substantially more in scope than a compilation.

Multiple-Choice Answers and Explanations

Answers

1. d	—	—	14. d	—	—	27. a	—	—	40. a	—	—	53. c	—	—
2. c	—	—	15. d	—	—	28. d	—	—	41. b	—	—	54. c	—	—
3. c	—	—	16. c	—	—	29. a	—	—	42. d	—	—	55. c	—	—
4. d	—	—	17. b	—	—	30. c	—	—	43. b	—	—	56. b	—	—
5. a	—	—	18. d	—	—	31. b	—	—	44. b	—	—	57. b	—	—
6. c	—	—	19. d	—	—	32. b	—	—	45. b	—	—	58. c	—	—
7. a	—	—	20. b	—	—	33. d	—	—	46. b	—	—	59. a	—	—
8. c	—	—	21. c	—	—	34. a	—	—	47. a	—	—			
9. b	—	—	22. a	—	—	35. d	—	—	48. a	—	—			
10. d	—	—	23. a	—	—	36. b	—	—	49. c	—	—			
11. b	—	—	24. b	—	—	37. b	—	—	50. c	—	—			
12. c	—	—	25. b	—	—	38. c	—	—	51. d	—	—	1st: ___/59 = ___%		
13. b	—	—	26. a	—	—	39. b	—	—	52. d	—	—	2nd: ___/59 = ___%		

Explanations

1. (d) The requirement is to identify the engagement for which Statements on Standards for Accounting and Review Services establish standards and procedures. Answer (d) is correct because the Statements apply when a CPA either compiles or reviews the financial statements of a nonissuer. Answer (a) is incorrect because the Statements do not apply when the CPA is assisting in adjusting the books of account for a partnership or other organization. Answer (b) is incorrect because the Statements only apply to nonissuer (nonpublic) entities. Answer (c) is incorrect because the Statements do not apply when processing the financial data for clients of other accounting firms.

2. (c) The requirement is to identify the authoritative body designated to promulgate standards concerning an accountant's association with unaudited financial statements of an entity that is **not** required to file financial statements with an agency regulating the issuance of the entity's securities. Answer (c) is correct because the Accounting and Review Services Committee is so designated. Answer (a) is incorrect because the Financial Accounting Standards Board is the authoritative body designated to promulgate financial accounting standards. Answer (b) is incorrect because Government Accountability Office is not one of the bodies designated by the AICPA to promulgate technical standards. Answer (d) is incorrect because the Auditing Standards Board is the authoritative body designated to promulgate statements on auditing standards. The AICPA *Code of Professional Conduct* presents the bodies designated to promulgate technical standards.

3. (c) The requirement is to determine which of the two listed accounting services an accountant may perform **without** being required to issue a compilation or review report under the Statements on Standards for Accounting and Review Services. Answer (c) is correct because the Statements on Standards for Accounting and Review Services do not apply to preparing a working trial balance or to preparing standard monthly journal entries. See SSARS for these and

additional circumstances in which the standards do not apply. Accordingly, no compilation or review report needs to be issued when these services are provided.

4. (d) The requirement is to determine whether an accountant can accept a compilation or a review engagement when s/he is unfamiliar with a prospective client's specialized industry accounting principles, but s/he plans to obtain the required level of knowledge prior to the engagement. Answer (d) is correct because an accountant may accept either a compilation or a review engagement in such circumstances.

5. (a) The requirement is to determine the correct statement concerning both an engagement to compile and an engagement to review a nonissuer's financial statements. Answer (a) is correct because neither a compilation nor a review contemplates obtaining an understanding of internal control. Answer (b) is incorrect because when performing a compilation the accountant need not be independent; independence is required for reviews. Answer (c) is incorrect because a review provides limited assurance. Answer (d) is incorrect because the accountant is not required to obtain a written management representation letter for a compilation; a management representation letter is required for a review.

6. (c) The requirement is to identify the type of assurance (if any) provided in a financial statement compilation report. Answer (c) is correct because the objective of a compilation is to present in the form of financial statements information that is the presentation of management (owners) without undertaking to express any assurance on the statements. Answer (a) is incorrect because accountants never provide absolute assurance. Answer (b) is incorrect because reviews result in limited (negative) assurance. Answer (d) is incorrect because audits, not compilations, provided reasonable assurance.

7. (a) The requirement is to identify the type of report that may be issued by a CPA who has invested in a company's

outstanding bonds payable. Answer (a) is correct because such an investment impairs independence and compilations allow a nonindependent CPA to perform the service when it is properly disclosed. Answers (b), (c), and (d) are all incorrect because independence is required for reviews, audits, and agreed-upon procedures engagements.

8. (c) The requirement is to determine which types of financial statement engagements require independence. Answer (c) is correct because independence is required for reviews, but not for compiling or preparing financial statements. Replies (a), (b), and (d) are all incorrect because they include one or more incorrect replies.

9. (b) The requirement is to determine which engagements an accountant's report is ordinarily issued for. Answer (b) is correct because a compilation report is required when a compilation is performed, but no report is ordinarily required when financial statements are prepared—prepared financial statement should include an adequate statement on each page of the financial statements indicating that no CPA provides any assurance on the financial statements. The only situation in which a preparation report (a disclaimer) is necessary is when the accountant is unable to include such a statement on each page of the financial statements. Answer (a) is incorrect because a compilation report is necessary. Answer (c) is incorrect because no preparation report is ordinarily issued, and a compilation report is issued. Answer (d) is incorrect because no preparation report is ordinarily issued.

10. (d) Answer d is correct because both financial statement preparation and compilation require an engagement letter. Answer a is incorrect because an engagement letter is required for both services. Answer b is incorrect because an engagement letter is required for financial statement preparation. Answer c is incorrect because an engagement letter is required for financial statement compilation.

11. (b) Answer b is correct because the SSARS do not require a representations letter for financial statement preparation. Answer a is incorrect because a representations letter is required for compilations. Answer c is incorrect because a representations letter is not required for financial statement preparation, but is required for financial statement compilation. Answer d is incorrect because a representations letter is not required for financial statement preparation.

12. (c) The requirement is to determine which is correct relating to an accountant's engagement to prepare a client's financial statements. Answer (c) is correct because a preparation engagement requires a representation (or equivalent document) signed by both management and the accountant.

13. (b) The requirement is to determine which is not correct relating to an accountant's engagement to prepare a client's financial statements. Answer (b) is correct because an accountant may assist the client in making significant judgments. Answer (a) is incorrect because the accountant should obtain an understanding of the client's financial reporting framework. Answer (c) is incorrect because a report such indication is included on each page of the financial statements. Answer (d) is incorrect because a written

engagement letter (or equivalent) is required and becomes a part of the engagement's documentation.

14. (d) The requirement is to identify the circumstance in which Statements on Standards for Accounting and Review Services apply. The Standards apply when a CPA submits unaudited financial statements of a nonissuer (nonpublic) entity to his or her client or others. Accordingly, answer (d) is correct. Answers (a), (b), and (c) are all incorrect because SSARS do not consider them financial statement preparation or compilation.

15. (d) Answer d is correct because when financial statements are prepared for presentation alongside a financial plan the SSARS consider it financial statement preparation; the key here is that the financial statements are *alongside* a financial plan—if the financial statements were *included in the plan* the SSARS would not apply. Answer a is incorrect because preparation of financial statements solely for submission to taxing authorities is an example of an accounting service for which the SSARS do not apply. Answer b is incorrect because entering transactions and processing payments is considered as providing assistance in preparing financial statements, not preparing financial statements. Answer c is incorrect because preparing financial statements in conjunction with such litigation services is an example of an accounting service for which the SSARS do not apply.

16. (c) Answer c is correct because a financial statement preparation engagement does not include an assessment of internal control. Answer a is incorrect because a copy of the financial statements should be included in the documentation of the engagement. Answer b is incorrect because an engagement letter should be received and should be included in the documentation of the engagement. Answer d is incorrect because significant professional judgments may be included in the documentation of the engagement.

17. (b) Answer b is correct because, when there is no intent to mislead users, such financial statements may be prepared when the omission of the disclosures is indicated. Answer a is incorrect because SSARS require disclosure of the omission of the notes. Answer c is incorrect because financial statement preparation standard ordinarily does not require preparation of an accountant's report. Answer d is incorrect because the engagement may be accepted.

18. (d) Answer d is correct because no written report is required unless the financial statements do not indicate that "no assurance is provided" on each page. Answer a is incorrect because no report is ordinarily required. Answer b is incorrect because no report is ordinarily required and because this is not a departure from GAAP. Answer c is incorrect because this is not considered a compilation.

19. (d) The requirement is to determine whether reproducing client-prepared financial statements without modification and preparing standard monthly journal entries are included in the provisions of Statements on Standards for Accounting and Review Services. Answer (d) is correct because SSARS do not apply to either of these situations.

- 20. (b)** The requirement is to determine whether either or both of (1) the additional audit effort necessary to complete the audit and (2) the reason for the change in the engagement should be considered by a CPA whose client has requested that an audit engagement be changed to a compilation. Answer (b) is correct because SSARS states that additional necessary audit effort and the reason for the change—as well as the additional cost to complete the audit—be considered.
- 21. (c)** The requirement is to determine when a CPA may compile and be associated with financial statements that omit disclosures required by GAAP. Answer (c) is correct because the CPA may compile such financial statements provided that the omission of substantially all disclosures (1) is clearly indicated in the audit report and (2) is not, to the CPA's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use the financial statements.
- 22. (a)** The requirement is to determine an accountant's responsibility relating to knowledge of the client's accounting principles and practices when performing a compilation. Answer (a) is correct because to compile financial statements the accountant should possess a general understanding of the nature of the entity's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, the accounting basis on which the financial statements are to be presented, and the form and content of the financial statements. Answer (b) is incorrect because the accountant need not have a general understanding of the entity's controls. Answer (c) is incorrect because no such consideration of risk factors is envisioned in a compilation. Answer (d) is incorrect because no such consideration of internal control awareness of senior management is made.
- 23. (a)** The requirement is to identify the procedure an accountant ordinarily performs in a compilation engagement of a nonissuer. Answer (a) is correct because the accountant is required, at a minimum, to read the financial statements to consider whether they are free from obvious material errors.
- 24. (b)** The requirement is to identify an accountant's reporting responsibility when performing a compilation and he or she determines that a going concern uncertainty has not been properly disclosed by a client. Answer (b) is correct because this is a departure from GAAP and results in modification, with addition of an emphasis-of-matter paragraph. Answer (a) is incorrect because the information on the client's ability to continue as a going concern should be included in the financial statements; if it is not, a departure from GAAP exists. Answer (c) is incorrect because adverse opinions are not issued based on compilations. Answer (d) is incorrect because qualified opinions are not issued based on compilations.
- 25. (b)** The requirement is to identify the statement that should be included in a compilation report. Answer (b) is correct because compilation reports indicate that the accountant compiled the financial statements in accordance with Statements on Standards for Accounting and Review Services.
- 26. (a)** The requirement is to determine how a CPA should indicate that a client's compiled financial statements were prepared in conformity with the income tax basis of accounting when the financial statements provide no such disclosure. Answer (a) is correct because if the basis of accounting is not disclosed in the financial statements, the accountant should disclose the basis in the compilation report. Answer (b) is incorrect because no such label is required. Answer (c) is incorrect because the auditor is not required to issue a special report. Answer (d) is incorrect because the auditor does not have to withdraw from the engagement.
- 27. (a)** The requirement is to determine how the compilation report should be modified to indicate that the entity's financial statements do not include all disclosures required by GAAP. Answer (a) is correct because while an accountant may compile such financial statements, the accountant must clearly indicate in the compilation report that substantially all disclosures required by GAAP have been omitted. Answer (b) is incorrect because the financial statements are not compiled on a comprehensive basis other than GAAP. Answer (c) is incorrect because a compilation may be performed on financial statements lacking such disclosures. Answer (d) is incorrect because these financial statements are not considered "special-purpose financial statements."
- 28. (d)** The requirement is to determine the information **least** likely to be included in the understanding with management that an accountant obtains when a compilation is to be performed. Answer (d) is correct because in a compilation an accountant obtains no assurance, not limited assurance; limited assurance is related to reviews. Answers (a), (b), and (c) are all items included in the understanding.
- 29. (a)** The requirement is to determine a CPA's responsibility when the first year of compiled comparative financial statements omit substantially all disclosures required by generally accepted accounting principles, while the second year's statements include such disclosures. Answer (a) is correct because the CPA may **not** report on the comparative financial statements because of a lack of comparability. Answers (b), (c), and (d) are all incorrect because they allow such reporting to occur under certain circumstances.
- 30. (c)** The requirement is to identify the statement that should **not** be included in a CPA's financial statement compilation report. Answer (c) is correct because a compilation report provides no assurance on the financial statements.
- 31. (b)** The requirement is to determine the representations made explicitly and implicitly when issuing a standard compilation report on a nonissuer's financial statements. Answer (b) is correct because the report explicitly states that the financial statements have not been audited and that the accountant has compiled them.
- 32. (b)** The requirement is to determine the appropriate date for an auditor's compilation report. SSARS require that the date of completion of compilation procedures should be used.
- 33. (d)** The requirement is to determine whether an accountant's compilation report must be printed on the accountant's letterhead, manually signed by the accountant, or both.

Answer (d) is correct because the professional standards require neither that the report be printed on the accountant's letterhead, nor that it be manually signed by the accountant. Answers (a), (b), and (c) are all incorrect because they include an inappropriate "yes" to one or both issues. See SSARS for information on reporting on a compilation of financial statements.

34. (a) The requirement is to identify the correct statement concerning compiled financial statements. Answer (a) is correct because a compilation report must be issued with compiled financial statements. Answer (b) is incorrect because note disclosures may be omitted. Answer (c) is incorrect because a written engagement letter is required. Answer (d) is incorrect because no such restriction is necessary.

35. (d) The requirement is to identify the circumstance in which a compilation report is **not** required. Answer (d) is correct because a compilation report is required whenever financial statements are compiled. Answers (a), (b), and (c) are all incorrect because a compilation report is required in such circumstances. Answers (b) and (c) are incorrect because when third parties are expected to use compiled financial statements, a compilation report is required. Answer (a) is incorrect because a compilation report is not always required.

36. (b) The requirement is to determine the effect of an immaterial direct financial interest on accountant independence. Answer (b) is correct because even immaterial direct financial interests impair the independence that is required for the performance of reviews. Answer (a) is incorrect because a CPA who lacks independence may compile those financial statements when this lack of independence is disclosed in the compilation report. Answer (c) is incorrect because a review report may not be issued. Answer (d) is incorrect because the CPA is not independent.

37. (b) The requirement is to identify the circumstance in which a CPA may issue a review report on a single financial statement. Answer (b) is correct because an accountant may issue a review report on a financial statement, such as a balance sheet, and not report on the other related financial statements if the scope of his or her inquiry and analytical procedures has not been restricted. Answer (a) is incorrect because the balance sheet need not be presented in prescribed form. Answer (c) is incorrect because the balance sheet may be used to obtain credit or to distribute to creditors. Answer (d) is incorrect because specialized accounting principles and practices in an industry may or may not need to be disclosed depending upon the circumstances.

38. (c) The requirement is to identify a CPA's responsibility when he or she believes that modification of the standard review report is **not** adequate to indicate deficiencies in financial statements affected by illegal acts. Answer (c) is correct because whenever a CPA believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements, he or she should withdraw from the review engagement and provide no further services with respect to those financial statements.

39. (b) The requirement is to identify the procedure **not** followed by an accountant in obtaining a reasonable basis for

the expression of limited assurance for a review of financial statements. Answer (b) is correct because reviews ordinarily do not include an assessment of the risk of fraud. Answer (a) is incorrect because reviews include analytical procedures. Answer (c) is incorrect because a review includes inquiries of management. Answer (d) is incorrect because auditors obtain written representation from management when performing a review.

40. (a) The requirement is to identify the procedure **least** likely to be performed in a review of the financial statements of a nonissuer. Answer (a) is correct because a review of a nonissuer financial statements does not specifically address observing the safeguards over access to and use of assets and records. Answers (b), (c), and (d) are all incorrect because they are included in the procedures suggested for a review by SSARS.

41. (b) The requirement is to identify the procedures that an accountant would perform during an engagement to review the financial statements of a nonissuer. Answer (b) is correct because SSARS require that the CPA obtain a representation letter. Answers (a), (c), and (d) are incorrect because they are not included in SSARS which present a list of procedures performed during a review.

42. (d) The requirement is to determine whether analytical procedures need to be performed on a compilation and/or a review engagement. Answer (d) is correct because a compilation does not require performance of analytical procedures, while a review does.

43. (b) The requirement is to determine the type of inquiry or analytical procedures ordinarily performed in an engagement to review a nonissuer's financial statements. Answer (b) is correct because an accountant will make inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements. Answer (a) is incorrect because the analytical procedures and other procedures involved in a review do not in general obtain corroborating audit evidence as do the procedures of an audit. Answer (c) is incorrect because the procedures for reviews are not specially designed to test management's assertion regarding continued existence. Answer (d) is incorrect because inquiries of the entity's attorney are not normally required when a review is being performed.

44. (b) The requirement is to determine the **most** likely procedures to be included in a review engagement of a non-issuer. Answer (b) is correct because a review consists primarily of inquiries and analytical procedures. Answer (a) is incorrect because a bank transfer schedule is generally not prepared for a review engagement. Answer (c) is incorrect because a review does not include assessing the control structure. Answer (d) is incorrect because cutoff tests on sales and purchases are not normally performed on a review. Note that the procedures included in answers (a), (c), and (d) are typically performed in an audit.

45. (b) The requirement is to determine the type of transaction the accountant is **most** likely to investigate during a

review when the year's accounts receivable did **not** conform to a predictable pattern. Answer (b) is correct because accounts receivable are generated from credit sales and an accountant would therefore investigate them. Answer (a) is incorrect because sales returns and allowances would be less likely to cause large shifts in accounts receivable than credit sales. Answer (c) is incorrect because it is less complete than answer (b) since sales of consigned goods represent only one possible type of sale that might impact accounts receivable. Answer (d) is incorrect because cash sales do not affect accounts receivable.

46. (b) The requirement is to identify the **most** likely procedure to be included in a review of a nonissuer's financial statements. Answer (b) is correct because SSARS state that reviews ordinarily include inquiries concerning actions taken at board of directors' meetings. Answer (a) is incorrect because reviews consist primarily of inquiry and analytical procedures and do not generally include confirmation of accounts receivable. Answer (c) is incorrect because a review of a nonpublic entity does not normally include obtaining an understanding of internal control or assessing control risk. Answer (d) is incorrect because distribution of a review report need not be limited. See SSARS for specific procedures included in reviews.

47. (a) The requirement is to identify a CPA's reporting responsibility when current year financial statements are compiled while the preceding year's financial statements were audited. Answer (a) is correct because a separate paragraph to the report should indicate (1) that the financial statements of the prior period were audited, (2) the date of the previous report, (3) the type of opinion expressed, (4) if the opinion was other than unmodified, the substantive reasons therefor and (5) that no auditing procedures were performed after the date of the previous report. Answer (b) is incorrect because no indication is made concerning updating the assessment of control risk. Answer (c) is incorrect because the CPA does not indicate reasons for changing from an audit to a compilation. Answer (d) is incorrect because the audit report may be relied on for the prior year's financial statements.

48. (a) The requirement is to determine a CPA's responsibilities when performing a review of a nonissuer's financial statements that contain uncorrected departures from GAAP and the CPA believes that the review report is not adequate to indicate the deficiencies. Answer (a) is correct because SSARS state that in such circumstances the CPA should withdraw from the engagement and provide no further services with respect to those financial statements. Answers (b) and (d) are incorrect because restricting distribution is not adequate or appropriate in such a circumstance. Answer (c) is incorrect because the standards on special reports do not apply in this circumstance.

49. (c) The requirement is to determine the listed requirement when an accountant is providing limited assurance that the financial statements of a nonissuer require **no** material modifications to be in accordance with generally accepted accounting principles. Accountants perform reviews to provide such limited assurance. Answer (c) is cor-

rect because obtaining an understanding of the accounting principles in the industry is required for reviews. Answer (a) is incorrect because reviews do not require the accountant to assess the risk of material misstatement. Answer (b) is incorrect because reviews generally do not include any communication with the entity's lawyer. Answer (d) is incorrect because an "audit" plan is not required since a review is being performed.

50. (c) The requirement is to identify the circumstances in which a CPA may issue a review report on the balance sheet of a nonissuer, and **not** report on the related financial statements. Answer (c) is correct because an accountant may issue a review report on one financial statement and not on the other related statements if the scope of the inquiry and analytical procedures has not been restricted. Answer (a) is incorrect because the CPA need not compile or report on the related statements of income, retained earnings, and cash flows when reviewing only the balance sheet. Answer (b) is incorrect because, when material modifications are needed, a CPA may still report on the balance sheet, but must indicate the modifications in the review report. Answer (d) is incorrect because the client need not be new.

51. (d) The requirement is to identify whether a review report is modified due to either inability to assess the risk of material misstatement due to fraud, a discovery of internal control deficiencies, or both. Answer (d) is correct because neither of these circumstances requires modification of a review report. Answers (a), (b), and (c) are all incorrect because they suggest that one or the other of these circumstances results in modification of a review report. A departure from GAAP is the primary cause of a review report modification. SSARS provide guidance on review reports.

52. (d) The requirement is to identify the reference that should be included in each page of a nonissuer's reviewed financial statements. Answer (d) is correct because no such reference is required.

53. (c) The requirement is to identify the statement that is included in an accountant's review report on the financial statements of a nonissuer. Answer (c) is correct because a review report includes a statement that a review consists principally of inquiries of company personnel and analytical procedures applied to financial data. See AR-C 90 for information that should be included in a review report.

54. (c) The requirement is to determine a CPA's reporting responsibility when an audit engagement for a nonissuer has been changed to a review engagement because of what the CPA believes to be a reasonable restriction on the scope of the audit. Answer (c) is correct because in such circumstances the CPA should neither include reference to the original engagement nor to the scope limitation.

55. (c) The requirement is to identify the correct statement relating to a CPA's report on comparative statements when the current year has been reviewed and the previous year has been audited. Answer (c) is correct because when a separate paragraph is being added to the CPA's review report the CPA should clearly indicate the difference in the levels of assurance for the two years. In this situation,

SSARS require the auditor to indicate that the previous year's financial statements were audited, the date of the report, the type of opinion expressed and if the opinion was other than unqualified, the substantive reasons for that opinion, and that no auditing procedures were performed after the date of the previous report. Answer (a) is incorrect because the review report is not solely intended for management or the board of directors. Answer (b) is incorrect because the prior year's audit report may still be appropriate. Answer (d) is incorrect because this statement does not need to be included within the review report.

56. (b) The requirement is to identify the statement included in the standard report issued by an accountant after reviewing the financial statements of a nonissuer. Answer (b) is correct because the report states that the accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. AR-C 90 presents the required disclosures for a review report.

57. (b) The requirement is to identify the information presented in a review report of financial statements of a nonissuer. Answer (b) is correct because the report indicates that all information included in the financial statements is the representation of the management of the entity.

58. (c) The requirement is to determine an accountant's reporting responsibility when associated with a nonissuer's reviewed statements which contain a material departure from generally accepted accounting principles. Answer (c) is correct because SSARS require the inclusion of a separate paragraph describing the departure. Answers (a) and (b) are incorrect because an adverse opinion or an "except for" qualified opinion may only be issued when an audit has been performed. Answer (d) is incorrect because expressing limited assurance (as is normally provided in reviews) on the financial statements is not adequate to disclose the departure.

59. (a) The requirement is to identify the reply which is correct concerning the content of a review report. Answer (a) is correct because a review report indicates that a review is substantially less in scope than an audit. Answer (b) is incorrect because a review report provides no information on internal control. Answer (c) is incorrect because while a review report states that the accountant is not aware of any material modifications that should be made to the financial statements, it does not provide limited assurance that the financial statements are fairly presented. Answer (d) is incorrect because while a review report does state that a review is substantially less in scope than an audit, it does not refer to a compilation.

Multiple-Choice Questions (1–58)

A.2. General Approaches to Audit Sampling—Nonstatistical and Statistical

- An advantage of using statistical over nonstatistical sampling methods in tests of controls is that the statistical methods
 - Can more easily convert the sample into a dual-purpose test useful for substantive testing.
 - Eliminate the need to use judgment in determining appropriate sample sizes.
 - Afford greater assurance than a nonstatistical sample of equal size.
 - Provide an objective basis for quantitatively evaluating sample risk.
- An advantage of statistical sampling over nonstatistical sampling is that statistical sampling helps an auditor to
 - Eliminate the risk of nonsampling errors.
 - Reduce the level of audit risk and materiality to a relatively low amount.
 - Measure the sufficiency of the evidential matter obtained.
 - Minimize the failure to detect errors and fraud.

A.3. Uncertainty and Audit Sampling

- The likelihood of assessing control risk too high is the risk that the sample selected to test controls
 - Does **not** support the auditor's planned assessed level of control risk when the true operating effectiveness of the control structure justifies such an assessment.
 - Contains misstatements that could be material to the financial statements when aggregated with misstatements in other account balances or transactions classes.
 - Contains proportionately fewer monetary errors or deviations from prescribed controls than exist in the balance or class as a whole.
 - Does not support the tolerable error for some or all of management's assertions.
- The risk of incorrect acceptance and the likelihood of assessing control risk too low relate to the
 - Allowable risk of tolerable misstatement.
 - Preliminary estimates of materiality levels.
 - Efficiency of the audit.
 - Effectiveness of the audit.
- Which of the following **best** illustrates the concept of sampling risk?
 - A randomly chosen sample may **not** be representative of the population as a whole on the characteristic of interest.
 - An auditor may select audit procedures that are **not** appropriate to achieve the specific objective.
 - An auditor may fail to recognize errors in the documents examined for the chosen sample.
 - The documents related to the chosen sample may **not** be available for inspection.
- In assessing sampling risk, the risk of incorrect rejection and the risk of assessing control risk too high relate to the
 - Efficiency of the audit.
 - Effectiveness of the audit.
 - Selection of the sample.
 - Audit quality controls.

Items 7 and 8 are based on the following information:

The diagram below depicts the auditor's estimated deviation rate compared with the tolerable rate, and also depicts the true population deviation rate compared with the tolerable rate.

	True State of Population	
	Deviation rate exceeds tolerable rate	Deviation rate is less than tolerable rate
Auditor's estimate based on sample results	I. Deviation rate exceeds tolerable rate	II. Deviation rate is less than tolerable rate
	III. Deviation rate is less than tolerable rate	IV. Deviation rate is less than tolerable rate

- In which of the situations would the auditor have properly concluded that control risk is at or below the planned assessed level?
 - I.
 - II.
 - III.
 - IV.
- As a result of tests of controls, the auditor assesses control risk too high and thereby increases substantive testing. This is illustrated by situation
 - I.
 - II.
 - III.
 - IV.
- While performing a test of details during an audit, an auditor determined that the sample results supported the conclusion that the recorded account balance was materially misstated. It was, in fact, not materially misstated. This situation illustrates the risk of
 - Assessing control risk too high.
 - Assessing control risk too low.
 - Incorrect rejection.
 - Incorrect acceptance.

A.4. Types of Audit Tests in Which Sampling May Be Used

10. The size of a sample designed for dual-purpose testing should be

- a. The larger of the samples that would otherwise have been designed for the two separate purposes.
- b. The smaller of the samples that would otherwise have been designed for the two separate purposes.
- c. The combined total of the samples that would otherwise have been designed for the two separate purposes.
- d. More than the larger of the samples that would otherwise have been designated for the two separate purposes, but less than the combined total of the samples that would otherwise have been designed for the two separate purposes.

A.5. Types of Statistical Sampling Plans

11. The expected population deviation rate of client billing errors is 3%. The auditor has established a tolerable rate of 5%. In the review of client invoices the auditor should use

- a. Stratified sampling.
- b. Variable sampling.
- c. Discovery sampling.
- d. Attribute sampling.

12. Which of the following sampling methods would be used to estimate a numerical measurement of a population, such as a dollar value?

- a. Attribute sampling.
- b. Stop-or-go sampling.
- c. Variables sampling.
- d. Random-number sampling.

13. For which of the following audit tests would an auditor most likely use attribute sampling?

- a. Making an independent estimate of the amount of a LIFO inventory.
- b. Examining invoices in support of the valuation of fixed asset additions.
- c. Selecting accounts receivable for confirmation of account balances.
- d. Inspecting employee time cards for proper approval by supervisors.

14. An underlying feature of random-based selection of items is that each

- a. Stratum of the accounting population be given equal representation in the sample.
- b. Item in the accounting population be randomly ordered.
- c. Item in the accounting population should have an opportunity to be selected.
- d. Item must be systematically selected using replacement.

15. Which of the following statistical selection techniques is least desirable for use by an auditor?

- a. Systematic selection.
- b. Stratified selection.
- c. Block selection.
- d. Sequential selection.

16. Which of the following statistical sampling plans does not use a fixed sample size for tests of controls?

- a. Dollar-unit sampling.
- b. Sequential sampling.
- c. PPS sampling.
- d. Variables sampling.

17. If certain forms are not consecutively numbered

- a. Selection of a random sample probably is not possible.
- b. Systematic sampling may be appropriate.
- c. Stratified sampling should be used.
- d. Random number tables cannot be used.

18. When performing a test of a control with respect to control over cash receipts, an auditor may use a systematic sampling technique with a start at any randomly selected item. The biggest disadvantage of this type of sampling is that the items in the population

- a. Must be systematically replaced in the population after sampling.
- b. May systematically occur more than once in the sample.
- c. Must be recorded in a systematic pattern before the sample can be drawn.
- d. May occur in a systematic pattern, thus destroying the sample randomness.

19. What is the primary objective of using stratification as a sampling method in auditing?

- a. To increase the confidence level at which a decision will be reached from the results of the sample selected.
- b. To determine the occurrence rate for a given characteristic in the population being studied.
- c. To decrease the effect of variance in the total population.
- d. To determine the precision range of the sample selected.

B.1. Tests of Controls—Sampling Risk

20. As a result of tests of controls, an auditor assessed control risk too low and decreased substantive testing. This assessment occurred because the true deviation rate in the population was

- a. Less than the risk of assessing control risk too low, based on the auditor's sample.
- b. Less than the deviation rate in the auditor's sample.
- c. More than the risk of assessing control risk too low, based on the auditor's sample.
- d. More than the deviation rate in the auditor's sample.

21. Which of the following factors is (are) considered in determining the sample size for a test of controls?

	Expected deviation rate	Tolerable deviation rate
a.	Yes	Yes
b.	No	No
c.	No	Yes
d.	Yes	No

22. Which of the following statements is correct concerning statistical sampling in tests of controls?

- a. Deviations from control procedures at a given rate usually result in misstatements at a higher rate.
- b. As the population size doubles, the sample size should also double.
- c. The qualitative aspects of deviations are not considered by the auditor.
- d. There is an inverse relationship between the sample size and the tolerable rate.

23. In determining the sample size for a test of controls, an auditor should consider the likely rate of deviations, the allowable risk of assessing control risk too low, and the

- a. Tolerable deviation rate.
- b. Risk of incorrect acceptance.
- c. Nature and cause of deviations.
- d. Population size.

24. Which of the following combinations results in a decrease in sample size in a sample for attributes?

	Risk of assessing control risk too low	Tolerable rate	Expected population deviation rate
a.	Increase	Decrease	Increase
b.	Decrease	Increase	Decrease
c.	Increase	Increase	Decrease
d.	Increase	Increase	Increase

25. An auditor is testing internal control procedures that are evidenced on an entity's vouchers by matching random numbers with voucher numbers. If a random number matches the number of a voided voucher, that voucher ordinarily should be replaced by another voucher in the random sample if the voucher

- a. Constitutes a deviation.
- b. Has been properly voided.
- c. Cannot be located.
- d. Represents an immaterial dollar amount.

26. An auditor plans to examine a sample of twenty purchase orders for proper approvals as prescribed by the client's control procedures. One of the purchase orders in the chosen sample of twenty cannot be found, and the auditor is unable to use alternative procedures to test whether that purchase order was properly approved. The auditor should

- a. Choose another purchase order to replace the missing purchase order in the sample.
- b. Consider this test of control invalid and proceed with substantive tests since internal control cannot be relied upon.
- c. Treat the missing purchase order as a deviation for the purpose of evaluating the sample.
- d. Select a completely new set of twenty purchase orders.

27. When assessing the tolerable rate, the auditor should consider that, while deviations from control procedures increase the risk of material misstatements, such deviations do not necessarily result in errors. This explains why

- a. A recorded disbursement that does not show evidence of required approval may nevertheless be a transaction that is properly authorized and recorded.
- b. Deviations would result in errors in the accounting records only if the deviations and the errors occurred on different transactions.
- c. Deviations from pertinent control procedures at a given rate ordinarily would be expected to result in errors at a higher rate.
- d. A recorded disbursement that is properly authorized may nevertheless be a transaction that contains a material error.

28. The objective of the tolerable rate in sampling for tests of controls of internal control is to

- a. Determine the probability of the auditor's conclusion based upon reliance factors.
- b. Determine that financial statements taken as a whole are not materially in error.
- c. Estimate the reliability of substantive tests.
- d. Estimate the range of procedural deviations in the population.

29. The tolerable rate of deviations for a test of a control is generally

- a. Lower than the expected rate of errors in the related accounting records.
- b. Higher than the expected rate of errors in the related accounting records.
- c. Identical to the expected rate of errors in related accounting records.
- d. Unrelated to the expected rate of errors in the related accounting records.

30. If the auditor is concerned that a population may contain exceptions, the determination of a sample size sufficient to include at least one such exception is a characteristic of

- a. Discovery sampling.
- b. Variables sampling.
- c. Random sampling.
- d. Dollar-unit sampling.

31. In determining the number of documents to select for a test to obtain assurance that all sales have been properly authorized, an auditor should consider the tolerable rate of deviation from the control activity. The auditor should also consider the

- I. Likely rate of deviations.
 II. Allowable risk of assessing control risk too high.

- a. I only.
 b. II only.
 c. Both I and II.
 d. Either I or II.

32. An auditor should consider the tolerable rate of deviation when determining the number of check requests to select for a test to obtain assurance that all check requests have been properly authorized. The auditor should also consider

	The average dollar value of the check requests	The allowable risk of assessing control risk too low
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

B.2. Statistical (Attributes) Sampling for Tests of Controls

33. Which of the following statements is correct concerning statistical sampling in tests of controls?

- a. As the population size increases, the sample size should increase proportionately.
 b. Deviations from specific internal control procedures at a given rate ordinarily result in misstatements at a lower rate.
 c. There is an inverse relationship between the expected population deviation rate and the sample size.
 d. In determining tolerable rate, an auditor considers detection risk and the sample size.

34. What is an auditor's evaluation of a statistical sample for attributes when a test of fifty documents results in three deviations if tolerable rate is 7%, the expected population deviation rate is 5%, and the allowance for sampling risk is 2%?

- a. Modify the planned assessed level of control risk because the tolerable rate plus the allowance for sampling risk exceeds the expected population deviation rate.
 b. Accept the sample results as support for the planned assessed level of control risk because the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate.
 c. Accept the sample results as support for the planned assessed level of control risk because the tolerable rate less the allowance for sampling risk equals the expected population deviation rate.
 d. Modify the planned assessed level of control risk because the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate.

Items 35 and 36 are based on the following:

An auditor desired to test credit approval on 10,000 sales invoices processed during the year. The auditor designed a statistical sample that would provide 1% risk of assessing control risk too low (99% confidence) that not more than 7% of the sales invoices lacked approval. The auditor estimated from previous experience that about 2 1/2% of the sales invoices lacked approval. A sample of 200 invoices was examined and 7 of them were lacking approval. The auditor then determined the achieved upper precision limit to be 8%.

35. In the evaluation of this sample, the auditor decided to increase the level of the preliminary assessment of control risk because the

- a. Tolerable rate (7%) was less than the achieved upper precision limit (8%).
 b. Expected deviation rate (7%) was more than the percentage of errors in the sample (3 1/2%).
 c. Achieved upper precision limit (8%) was more than the percentage of errors in the sample (3 1/2%).
 d. Expected deviation rate (2 1/2%) was less than the tolerable rate (7%).

36. The allowance for sampling risk was

- a. 5 1/2%
 b. 4 1/2%
 c. 3 1/2%
 d. 1%

37. Which of the following statements is correct concerning statistical sampling in tests of controls?

- a. The population size has little or no effect on determining sample size except for very small populations.
 b. The expected population deviation rate has little or no effect on determining sample size except for very small populations.
 c. As the population size doubles, the sample size also should double.
 d. For a given tolerable rate, a larger sample size should be selected as the expected population deviation rate decreases.

B.3. Nonstatistical Sampling for Tests of Controls

38. When an auditor has chosen a random sample and is using nonstatistical attributes sampling, that auditor

- a. Need not consider the risk of assessing control risk too low.
 b. Has committed a nonsampling error.
 c. Will have to use discovery sampling to evaluate the results.
 d. Should compare the deviation rate of the sample to the tolerable deviation rate.

C.1. Sampling Risk

39. How would increases in tolerable misstatement and assessed level of control risk affect the sample size in a substantive test of details?

	Increase in tolerable misstatement	Increase in assessed level of control risk
a.	Increase sample size	Increase sample size
b.	Increase sample size	Decrease sample size
c.	Decrease sample size	Increase sample size
d.	Decrease sample size	Decrease sample size

40. Which of the following courses of action would an auditor **most** likely follow in planning a sample of cash disbursements if the auditor is aware of several unusually large cash disbursements?

- Set the tolerable rate of deviation at a lower level than originally planned.
- Stratify the cash disbursements population so that the unusually large disbursements are selected.
- Increase the sample size to reduce the effect of the unusually large disbursements.
- Continue to draw new samples until all the unusually large disbursements appear in the sample.

41. Which of the following sample planning factors would influence the sample size for a substantive test of details for a specific account?

	Expected amount of misstatements	Measure of tolerable misstatement
a.	No	No
b.	Yes	Yes
c.	No	Yes
d.	Yes	No

42. When planning a sample for a substantive test of details, an auditor should consider tolerable misstatement for the sample. This consideration should

- Be related to the auditor's business risk.
- Not be adjusted for qualitative factors.
- Be related to preliminary judgments about materiality levels.
- Not be changed during the audit process.

43. A number of factors influences the sample size for a substantive test of details of an account balance. All other factors being equal, which of the following would lead to a larger sample size?

- Greater reliance on internal control.
- Greater reliance on analytical procedures.
- Smaller expected frequency of errors.
- Smaller measure of tolerable misstatement.

44. In estimation sampling for variables, which of the following must be known in order to estimate the appropriate sample size required to meet the auditor's needs in a given situation?

- The qualitative aspects of errors.
- The total dollar amount of the population.
- The acceptable level of risk.
- The estimated rate of misstatements in the population.

45. An auditor established a \$60,000 tolerable misstatement for an asset with an account balance of \$1,000,000. The auditor selected a sample of every twentieth item from the population that represented the asset account balance and discovered overstatements of \$3,700 and understatements of \$200. Under these circumstances, the auditor **most** likely would conclude that

- There is an unacceptably high risk that the actual misstatements in the population exceed the tolerable misstatement because the total projected misstatement is more than the tolerable misstatement.
- There is an unacceptably high risk that the tolerable misstatement exceeds the sum of actual overstatements and understatements.
- The asset account is fairly stated because the total projected misstatement is less than the tolerable misstatement.
- The asset account is fairly stated because the tolerable misstatement exceeds the net of projected actual overstatements and understatements.

C.2. Probability-Proportional-to-Size (PPS) Sampling

46. Which of the following statements is correct concerning probability-proportional-to-size (PPS) sampling, also known as dollar unit sampling?

- The sampling distribution should approximate the normal distribution.
- Overstated units have a lower probability of sample selection than units that are understated.
- The auditor controls the risk of incorrect acceptance by specifying that risk level for the sampling plan.
- The sampling interval is calculated by dividing the number of physical units in the population by the sample size.

47. Hill has decided to use probability-proportional-to-size (PPS) sampling, sometimes called dollar-unit sampling, in the audit of a client's accounts receivable balances. Hill plans to use the following PPS sampling table:

TABLE
Reliability Factors for Overstatements

Number of over- statements	Risk of incorrect acceptance				
	1%	5%	10%	15%	20%
0	4.61	3.00	2.31	1.90	1.61
1	6.64	4.75	3.89	3.38	3.00
2	8.41	6.30	5.33	4.72	4.28
3	10.05	7.76	6.69	6.02	5.52
4	11.61	9.16	8.00	7.27	6.73

Additional information

Tolerable misstatements (net of effect of expected misstatements)	\$24,000
Risk of incorrect acceptance	20%
Number of misstatements	1
Recorded amount of accounts receivable	\$240,000
Number of accounts	360

What sample size should Hill use?

- a. 120
- b. 108
- c. 60
- d. 30

48. In a probability-proportional-to-size sample with a sampling interval of \$5,000, an auditor discovered that a selected account receivable with a recorded amount of \$10,000 had an audit amount of \$8,000. If this were the only error discovered by the auditor, the projected error of this sample would be

- a. \$1,000
- b. \$2,000
- c. \$4,000
- d. \$5,000

C.3. Classical Variables Sampling

49. An auditor is determining the sample size for an inventory observation using mean-per-unit estimation, which is a variables sampling plan. To calculate the required sample size, the auditor usually determines the

	Variability in the dollar amounts of inventory items	Risk of incorrect acceptance
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

50. In statistical sampling methods used in substantive testing, an auditor **most** likely would stratify a population into meaningful groups if

- a. Probability-proportional-to-size (PPS) sampling is used.
- b. The population has highly variable recorded amounts.

- c. The auditor's estimated tolerable misstatement is extremely small.
- d. The standard deviation of recorded amounts is relatively small.

51. The use of the ratio estimation sampling technique is most effective when

- a. The calculated audit amounts are approximately proportional to the client's book amounts.
- b. A relatively small number of differences exist in the population.
- c. Estimating populations whose records consist of quantities, but not book values.
- d. Large overstatement differences and large understatement differences exist in the population.

52. In the application of statistical techniques to the estimation of dollar amounts, a preliminary sample is usually taken primarily for the purpose of estimating the population

- a. Variability.
- b. Mode.
- c. Range.
- d. Median.

53. Using statistical sampling to assist in verifying the year-end accounts payable balance, an auditor has accumulated the following data:

	Number of accounts	Book balance	Balance determined by the auditor
Population	4,100	\$5,000,000	?
Sample	200	\$250,000	\$300,000

Using the ratio estimation technique, the auditor's estimate of year-end accounts payable balance would be

- a. \$6,150,000
- b. \$6,000,000
- c. \$5,125,000
- d. \$5,050,000

54. Use of the ratio estimation sampling technique to estimated dollar amounts is inappropriate when

- a. The total book value is known and corresponds to the sum of all the individual book values.
- b. A book value for each sample item is unknown.
- c. There are some observed differences between audited values and book values.
- d. The audited values are nearly proportional to the book values.

55. An auditor is performing substantive tests of pricing and extensions of perpetual inventory balances consisting of a large number of items. Past experience indicates numerous pricing and extension errors. Which of the following statistical sampling approaches is most appropriate?

- a. Unstratified mean-per-unit.
- b. Probability-proportional-to-size.
- c. Stop or go.
- d. Ratio estimation.

56. The major reason that the difference and ratio estimation methods would be expected to produce audit efficiency is that the

- a. Number of members of the populations of differences or ratios is smaller than the number of members of the population of book values.
- b. Beta risk may be completely ignored.
- c. Calculations required in using difference or ratio estimation are less arduous and fewer than those required when using direct estimation.
- d. Variability of the populations of differences or ratios is less than that of the populations of book values or audited values.

57. Which of the following statements is correct concerning the auditor's use of statistical sampling?

- a. An auditor needs to estimate the dollar amount of the standard deviation of the population to use classical variables sampling.
- b. An assumption of PPS sampling is that the underlying accounting population is normally distributed.

- c. A classical variables sample needs to be designed with special considerations to include negative balances in the sample.
- d. The selection of zero balances usually does not require special sample design considerations when using PPS sampling.

C.4. Comparison of PPS Sampling to Classical Variables Sampling

58. Which of the following **most** likely would be an advantage in using classical variables sampling rather than probability-proportional-to-size (PPS) sampling?

- a. An estimate of the standard deviation of the population's recorded amounts is not required.
- b. The auditor rarely needs the assistance of a computer program to design an efficient sample.
- c. Inclusion of zero and negative balances generally does not require special design considerations.
- d. Any amount that is individually significant is automatically identified and selected.

Multiple-Choice Answers and Explanations

Answers

1. d ___	13. d ___	25. b ___	37. a ___	49. a ___
2. c ___	14. c ___	26. c ___	38. d ___	50. b ___
3. a ___	15. c ___	27. a ___	39. c ___	51. a ___
4. d ___	16. b ___	28. d ___	40. b ___	52. a ___
5. a ___	17. b ___	29. b ___	41. b ___	53. b ___
6. a ___	18. d ___	30. a ___	42. c ___	54. b ___
7. d ___	19. c ___	31. a ___	43. d ___	55. d ___
8. b ___	20. d ___	32. c ___	44. c ___	56. d ___
9. c ___	21. a ___	33. b ___	45. a ___	57. a ___
10. a ___	22. d ___	34. d ___	46. c ___	58. c ___
11. d ___	23. a ___	35. a ___	47. d ___	1st: ___/58 = ___%
12. c ___	24. c ___	36. b ___	48. b ___	2nd: ___/58 = ___%

Explanations

1. (d) The requirement is to identify an advantage of statistical sampling over nonstatistical sampling. Answer (d) is correct because statistical sampling helps the auditor to: (1) design an efficient sample, (2) measure the sufficiency of the evidential matter obtained, and (3) evaluate the sample results (AICPA Audit Sampling Guide). Answer (a) is incorrect because dual-purpose tests, which both test a control and serve as substantive test, may be performed with either a statistical or a nonstatistical sample. Answer (b) is incorrect because both statistical and nonstatistical sampling require the use of judgment, although that judgment is quantified when statistical sampling is used. Answer (c) is incorrect because either statistical or nonstatistical sampling may provide equal assurance to the auditor.

2. (c) The requirement is to identify an advantage of statistical sampling over nonstatistical sampling. Answer (c) is correct because statistical sampling helps the auditor to: (1) design an efficient sample, (2) measure the sufficiency of the evidential matter obtained, and (3) evaluate the sample results (AICPA Audit Sampling Guide). Answer (a) is incorrect because the risk of nonsampling errors is not directly affected by whether statistical or nonstatistical sampling is used. Answer (b) is incorrect because either statistical or nonstatistical sampling can be used to reduce the level of audit risk to a low level; the materiality level should not be affected by the type of sampling used. Answer (d) is incorrect because either statistical or nonstatistical sampling may be used to minimize the failure to detect errors and fraud.

3. (a) The requirement is to determine the meaning of the likelihood of assessing control risk too high in a test of controls. Answer (a) is correct because the risk of assessing control risk too high is the risk that the sample does **not**

support the auditor's planned assessed level of control risk when the true operating effectiveness of the control structure justifies such an assessment. Answer (b) is incorrect because the risk of assessing control risk too high relates to the deviation rate from a control procedure in a population, not to monetary misstatements. Answer (c) is incorrect because the risk of assessing control risk too high does not directly relate to monetary misstatements. Answer (d) is incorrect because tolerable error (misstatement) relates to variables sampling applied to substantive testing and not to tests of controls and because the meaning of "support the tolerable error" is uncertain.

4. (d) The requirement is to determine the nature of the risk of incorrect acceptance and the risk of assessing control risk too low. Answer (d) is correct because the risk of incorrect acceptance and the risk of assessing control risk too low relate to the effectiveness of an audit in detecting an existing material misstatement or deviation. Answer (a) is incorrect because the term "allowable risk of tolerable misstatement" is not used in the professional standards. Answer (b) is incorrect because preliminary estimates of materiality levels relate most directly to the risk of incorrect acceptance, and only indirectly to the risk of assessing control risk too low. Answer (c) is incorrect because the risk of incorrect rejection and the risk of assessing control risk too high relate to the efficiency of the audit.

5. (a) The requirement is to determine which answer represents the concept of sampling risk. Sampling risk arises from the possibility that an auditor's conclusions based upon a sample would differ from the conclusions which would be drawn from examining the entire population (i.e., the risk that the sample examined is not representative of the population). Answers (b), (c), and (d) are all incorrect because they relate to errors which could occur even if 100% of the population were examined, that is, nonsampling risk.

6. (a) The requirement is to determine what is related to the risk of incorrect rejection and the risk of assessing control risk too high. Answer (a) is correct because AU-C 530 states that the risk of incorrect rejection and the risk of assessing control risk too high relate to the efficiency of the audit. These two errors generally result in an auditor performing unnecessary additional procedures. Answer (b) is incorrect because the risk of incorrect acceptance and the risk of assessing control risk too low relate to the effectiveness of an audit. Answer (c) is incorrect because the risks do not relate directly to the actual selection of the sample. Answer (d) is incorrect because the audit quality controls do not directly mention either of these risks.

7. (d) The requirement is to determine the situation in which an auditor has properly concluded that control risk is at or below the planned assessed level. Answer (d) is correct because to support the planned level, the deviation rate must be less than the tolerable rate and the auditor must conclude that the deviation rate is less than the tolerable rate. Answer (a) is incorrect because it represents a situation in which the auditor appropriately decides that the deviation rate exceeds the tolerable rate. Answer (b) is incorrect because it represents a situation in which an auditor erroneously concludes that the deviation rate exceeds the tolerable rate when it actually does not. Answer (c) is incorrect because the auditor erroneously concludes that the deviation rate is less than the tolerable rate when it actually exceeds it.

8. (b) The requirement is to determine the situation in which the auditor assesses control risk too high and thereby increases substantive testing. Answer (b) is correct because to assess control risk too high, an auditor must estimate that the deviation rate exceeds the tolerable rate when it actually is less than the tolerable rate. Answer (a) is incorrect because it represents a situation in which the auditor appropriately decides that the deviation rate exceeds the tolerable rate. Answer (c) is incorrect because the auditor erroneously concludes that the deviation rate is less than the tolerable rate when it actually exceeds the tolerable rate. Answer (d) is incorrect because to properly rely on internal control, the deviation rate must be less than the tolerable rate and the auditor must conclude that the deviation rate is less than the tolerable rate.

9. (c) The requirement is to determine the type of risk demonstrated when an auditor concludes that an account is misstated when in fact it is not. Answer (c) is correct because the risk of incorrect rejection is the risk that the sample supports the conclusion that the recorded account balance is materially misstated when the account is not misstated. Answers (a) and (b) are incorrect because the risk of assessing control risk too high and the risk of assessing control risk too low relate to tests of controls, and not to substantive tests of details. Answer (d) is incorrect because the risk of incorrect acceptance is the risk that the sample support the conclusion that the account is not misstated when in fact it is misstated.

10. (a) The requirement is to identify the correct statement with respect to the size of a sample required for dual purpose testing. Answer (a) is correct because the auditor should select the larger of the required sample sizes.

11. (d) The requirement is to identify the type of sampling involved in a review of client invoices in which an expected population deviation rate and an established tolerable rate are provided. Answer (d) is correct because attribute sampling is used to reach a conclusion about a population in terms of a rate of occurrence (Audit Sampling Guide). Answer (a) is incorrect because stratified sampling is generally used to reach a dollar-based conclusion in variables sampling approaches. Answer (b) is incorrect because, as indicated, variables sampling deals with a dollar amount conclusion, not deviation rates. Answer (c) is incorrect because discovery sampling is only used in cases in which the auditor expects deviation rates to be extremely low (approaching zero).

12. (c) The requirement is to identify the sampling method that would be used to estimate a numerical measurement such as a dollar value of a population. Answer (c) is correct because sampling for variables addresses such numerical measurements. Answer (a) is incorrect because attributes sampling deals with deviation rates. Answer (b) is incorrect because stop-or-go sampling (also referred to as sequential sampling) is a form of attributes sampling. Answer (d) is incorrect because random-number sampling is simply a sample selection technique that may be used with either an attributes or a variables form of sampling; accordingly, a numerical measurement such as a dollar value is not necessary for random-number sampling.

13. (d) The requirement is to determine the audit test for which an auditor would **most** likely use attribute sampling. Answer (d) is correct because attribute sampling is used to reach a conclusion about a population in terms of a rate of occurrence. Here the rate of occurrence will be the rate of (un) approved time cards. Answers (a), (b), and (c) are all incorrect because they all relate more directly to variables sampling which is generally used to reach conclusion about a population in terms of a dollar amount. See the AICPA Audit and Accounting Guide, Audit Sampling, and AU-C 530 for more information on audit sampling.

14. (c) The requirement is to determine the correct statement with respect to random sampling. Answer (c) is correct because every item in the accounting population should have an opportunity to be selected. Answer (a) is incorrect because with stratified random sampling, each stratum need not be given equal representation. Answer (b) is incorrect because while sample units should be randomly selected, there is no requirement that the accounting population be randomly ordered. Answer (d) is incorrect because random sampling, by its very nature, is not systematic. Additionally, random sampling may be performed without replacement.

15. (c) The requirement is to determine the least desirable statistical selection technique. Answer (c), block selection, is correct because, ideally, a sample should be selected from the entire set of data to which the resulting conclusions are to be applied. When block sampling is used, the selection of blocks often precludes items from being so selected. In most cases, systematic [answer (a)], stratified [answer (b)], and sequential [answer (d)] selection techniques all provide a better representation of the entire population than does block selection.

16. (b) The requirement is to identify the type of sampling plan that does **not** use a fixed sample size for tests of controls. Answer (b) is correct because sequential sampling results in the selection of a sample in several steps, with each step conditional on the result of the previous steps. Therefore, sample size will vary depending upon the number of stages that prove necessary. Answers (a), (c), and (d) are all incorrect because dollar-unit sampling, PPS sampling, and variables sampling all use a fixed sample size.

17. (b) The requirement is to identify the correct statement concerning a statistical sampling application where the population consists of forms which are **not** consecutively numbered. Answer (b) is correct because systematic sampling is a procedure where a random start is obtained and then every n th item is selected. For example, a sample of forty from a population of a thousand would require selecting every 25th item after obtaining a random start between items 1 through 25. Answer (a) is incorrect because selection of a random sample is possible even though the population is not consecutively numbered. Answer (c) is incorrect because there is no special reason for using stratified sampling. Stratified sampling breaks down the population into subpopulations and applies different selection methods to each subpopulation. This selection method is used when the population consists of different types of items (e.g., large balances and small balances). Answer (d) is incorrect because random number tables can be used even though the forms are not consecutively numbered. If random numbers are selected for which there are no forms, they are ignored. This is the same as if there were 86,000 items in a consecutively numbered population and random numbers selected between 86,000 and 99,999 are ignored.

18. (d) Answer (d) is correct because systematic items occurrence in a population **may** destroy a sample's randomness. Answer (a) is incorrect because items need not be replaced in the population, and therefore is not a disadvantage of systematic sampling. Answer (b) is incorrect because an individual item will not occur more than once in a sample when systematic sampling is being used (because the auditor selects every n th item). Answer (c) is incorrect because systematic sampling refers to the type of sampling selection plan used and not the manner in which items in the population are recorded. Also, as indicated in (d) above, a systematic pattern in the population is a hindrance to systematic sampling.

19. (c) Stratified sampling is a technique of breaking the population down into subpopulations and applying different sample selection methods to the subpopulations. Stratified sampling is used to minimize the variance within the overall population [answer (c)]. Recall that as variance increases, so does the required sample size (because of the extreme values). Thus, stratification allows the selection of subpopulations to reduce the effect of dispersion in the population.

20. (d) The requirement is to identify the circumstance that would cause an auditor to assess control risk too low and decrease substantive testing inappropriately. Answer (d) is correct because when the true deviation rate in the population exceeds that in the sample, the auditor may assess control risk too low. The AICPA Audit Sampling Guide discusses

tests of controls and attributes sampling in its second chapter. Answers (a) and (c) are incorrect because the true deviation rate and the risk of assessing control risk too low do not have such a relationship, either positive or negative. Answer (b) is incorrect because a deviation rate in the population that is less than the deviation rate in the auditor's sample may lead the auditor to assess control risk too high.

21. (a) The requirement is to determine whether the expected deviation rate, the tolerable deviation rate, or both affect the sample size for a test of controls. Answer (a) is correct because attribute sampling formulas and tables used in auditing generally require the auditor to specify an expected deviation rate, a tolerable deviation rate and the risk of assessing control risk too low. See AICPA Audit Sampling Guide and AU-C 530 for more information on audit sampling.

22. (d) The requirement is to identify the correct statement about sampling for attributes. Answer (d) is correct because the sample size increases as the tolerable rate decreases, an inverse relationship. Answer (a) is incorrect because many deviations do not necessarily result in a misstatement. Answer (b) is incorrect because a doubling of the population size will result in less than a doubling of the required sample size. Answer (c) is incorrect because auditors must consider the qualitative aspects of deviations.

23. (a) The requirement is to identify the information needed in addition to the likely rate of deviations and the allowable risk of assessing control risk too low to determine the sample size for a test of controls in an attributes sampling plan. Answer (a) is correct because the tolerable deviation rate is also needed. Answer (b) is incorrect because the risk of incorrect acceptance relates to variables sampling applied to substantive testing, not attributes sampling applied to tests of controls. Answer (c) is incorrect because the auditor will examine the nature and cause of deviations after the sample has been selected. Answer (d) is incorrect because auditors often do not consider population size when performing attributes sampling applied to tests of controls.

24. (c) The requirement is to determine when a sample size would be decreased when sampling for attributes. Answer (c) is correct because the sample size will decrease when the risk of assessing control risk too low is increased, the tolerable rate is increased, and the expected population deviation rate is decreased (Audit and Accounting Guide, Audit Sampling). Answers (a), (b), and (d) are all incorrect because they include combinations of changes that would not necessarily decrease sample size.

25. (b) The requirement is to identify the correct statement with respect to treatment of a voided voucher that has been selected in a sample. Answer (b) is correct because the AICPA Audit Sampling Guide states that the auditor should obtain reasonable assurance that the voucher has been properly voided, and should then replace it with another voucher. Answer (a) is incorrect because the voided voucher is not normally considered to be a deviation. Answer (c) is incorrect because the auditor must obtain reasonable assurance that the misplaced voucher has been voided. Answer (d) is incorrect because the level of materiality normally does not directly affect the decision.

26. (c) The requirement is to determine the proper method of handling a sample item which cannot be located for evaluation purposes. Answer (c) is correct because an auditor would ordinarily consider the selected item to be a deviation. Answers (a) and (d) are incorrect since a possible cause for the missing purchase order could be a breakdown in one of the controls of the system. Thus, in selecting a new sample item(s) the auditor may be ignoring a portion of the population which is in error and may be artificially skewing the results of the tests performed on the sample. Answer (b) is incorrect because there is no reason to believe that the entire test is invalid and cannot be relied upon.

27. (a) The requirement is to determine why deviations from control procedures do **not** necessarily result in errors. Answer (a) is correct because it provides an example of a situation in which a deviation from a control procedure exists (lack of documentation of transaction approval), although the entry was authorized and proper. Thus, such a deviation does not necessarily result in an error in the financial statements. Answer (b) is incorrect because a deviation from control procedure and an error may occur in the same transaction. Answer (c) is incorrect since the fact that all deviations do not lead to errors will result in a lower error rate. Answer (d) is incorrect because while it represents a correct statement, it does not follow from the point of the question which is based on the idea that deviations do not directly result in errors.

28. (d) The requirement is to determine the objective of the tolerable rate in sampling. Tolerable rate is calculated to determine the range of procedural deviations in the population. Answer (a) is incorrect because probabilities relate more directly to reliability. Answer (b) is incorrect because errors on financial statements in materiality terms relate to variables sampling. Answer (c) is incorrect because the tolerable rate does not relate directly to substantive tests.

29. (b) The requirement is to determine the correct relationship between the tolerable rate of deviations and the expected rate of deviations for a test of a control. The tolerable rate of deviations is the maximum rate of deviations from a prescribed control procedure that an auditor would be willing to accept and, unless the expected error rate is lower, reliance on internal control is not justified. Answer (a) is incorrect because if the tolerable rate of deviations is less than the expected rate, the auditor would not plan to rely on internal control and would therefore omit tests of controls. Answer (c) is incorrect because testing of controls is inappropriate if the expected rate of errors equals the tolerable rate of deviations (mathematically, the precision of zero makes the sample size equal to population size). Answer (d) is incorrect because, as indicated above, to perform tests of controls one must assume that the tolerable rate of deviations is more than the expected error rate.

30. (a) The requirement is to determine the type of sampling which is most directly related to finding at least one exception. Discovery sample sizes and related discovery sampling tables are constructed to measure the probability of at least one error occurring in a sample if the error rate in the population exceeds the tolerable rate. Answer (b) is incorrect because variables sampling need not include at least one exception

(mean per unit sampling, for example, needs no errors).

Answer (c) is incorrect since random sampling only deals with the technique used to select items to be included in the sample. Answer (d) is incorrect because dollar-unit sampling results are not directly related to finding at least one exception.

31. (a) The requirement is to determine whether an auditor should consider the likely rate of deviation, the allowable risk of assessing control risk too high, or both, when performing a test of a control. Answer (a) is correct because an auditor will consider the likely rate of deviations, but will not ordinarily consider the allowable risk of assessing control risk too high when following the approach outlined in the AICPA Audit Sampling Guide.

32. (c) The requirement is to determine whether an auditor would consider the average dollar value of check requests, the allowable risk of assessing control risk too low, or both, when testing whether check requests have been properly authorized. Answer (c) is correct because a test of authorization such as this is an attributes test which requires the auditor to determine an allowable risk of assessing control risk too low, but does not deal directly with dollar values. Answers (a), (b), and (d) are all incorrect because they include incorrect combinations of the replies. See AU-C 530 and the AICPA Audit Sampling Guide for information on sampling.

33. (b) The requirement is to identify the correct statement concerning statistical sampling in tests of controls. Answer (b) is correct because while deviations from pertinent control procedures increase the risk of material misstatements, any specific deviation need not necessarily result in a misstatement. For example, a recorded disbursement that does not show evidence of required approval might nevertheless be a transaction that is properly authorized and recorded (AICPA Audit Sampling Guide). Answer (a) is incorrect because increases in population size result in small increases in sample size. Answer (c) is incorrect because a direct relationship, not an inverse relationship, exists between the expected population deviation rate and the sample size—that is, increases in the expected population deviation rate result in an increase in the required sample size. Answer (d) is incorrect because when determining the tolerable rate, the auditor does not yet have the required sample size.

34. (d) The requirement is to determine the proper evaluation of a statistical sample for attributes when a test of 50 documents results in 3 deviations, given a tolerable rate of 7%, an expected population deviation rate of 5%, and an allowance for sampling risk of 2%. Answer (d) is correct because when the deviation rate plus the allowance for sampling risk exceeds the tolerable rate, the assessed level of control risk may increase. Here the deviation rate of 6% (3 deviations/50 documents) plus the allowance for sampling risk of 2% equals 8% and exceeds the tolerable rate of 7%. Answer (a) is incorrect because the tolerable rate plus the allowance for sampling risk will always exceed the expected population deviation rate when tests of controls are being performed. Answer (b) is incorrect because when the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate the sample results do not support the planned assessed level of control risk. Answer (c) is incorrect because

the tolerable rate less the allowance for sampling risk should be compared with the actual deviation rate.

35. (a) The requirement is to determine the circumstance in which an auditor would decide to increase the level of the preliminary assessment of control risk. Answer (a) is correct because the assessment of control risk will increase when the achieved upper precision limit (here 8%) exceeds the tolerable rate (here 7%). Answer (b) is incorrect because the expected deviation rate was 2 1/2%, not 7%. Also, if the expected deviation rate is higher than the percentage of error in the sample, the preliminary assessment does not need to be increased. Answer (c) is incorrect because the achieved upper precision limit will always exceed the percentage of errors in the sample. Answer (d) is incorrect because, in circumstances in which the auditor decides to sample the population, the expected deviation rate will always be less than the tolerable rate.

36. (b) The requirement is to determine the allowance for sampling risk of the presented sample. When considering the allowance for sampling risk, one may consider both the planned allowance for sampling risk or the adjusted allowance based on the sample results. Answer (b) is correct because both the planned and adjusted allowance for sampling risk are 4 1/2% (7% – 2.5% for planning purposes, and 8% – 3.5% [7/200] as adjusted).

37. (a) The requirement is to identify the correct statement concerning statistical sampling for tests of controls. Answer (a) is correct because population size has little or no effect on sample size. Answer (b) is incorrect because the population deviation rate has a significant effect on sample size. Answer (c) is incorrect because sample size increases to a much lesser extent than doubling as the population size doubles. Answer (d) is incorrect because for a given tolerable rate, a smaller, and not a larger, sample size should be selected as the expected population deviation rate decreases.

38. (d) The requirement is to identify the proper statement concerning a random sample when nonstatistical attributes sampling is being used. Answer (d) is correct because the deviation rate of the sample should be compared to the tolerable deviation rate regardless of whether statistical or nonstatistical sampling is being used. Answer (a) is incorrect because the risk of assessing control risk too low should be considered, although it may be done judgmentally. Answer (b) is incorrect because nonsampling error relates to “human” type errors such as not identifying a deviation, and not specifically to the use of nonstatistical sampling. Answer (c) is incorrect because discovery sampling will not be used to evaluate the results.

39. (c) The requirement is to determine whether either or both of an increase in tolerable misstatement and an increase in the assessed level of control risk increase sample size in a substantive test of details. Answer (c) is correct because while an increase in tolerable misstatement decreases sample size for a substantive test of details, an increase in the assessed level of control risk increases the sample size for a substantive test of details because a lower level of detection risk is required.

40. (b) The requirement is to determine the proper course of action when an auditor is planning a sample of cash disbursements and he or she is aware of several unusually large cash disbursements. Given the description of the several disbursements as “unusually large,” an auditor will generally test them. Answer (b) is therefore correct because stratifying the population will allow the auditor to ensure inclusion of the disbursements. The sampling procedure (selecting less than all items) will then be applied only to the smaller disbursements. Answer (a) is incorrect because the existence of the large disbursements will have no necessary relationship to the tolerable rate of deviation when attributes sampling is being used. Answer (c) is incorrect because while increasing the sample size might be appropriate in some variables sampling applications (we are not told in this problem whether attributes or variables sampling is being followed), the fact that the disbursements are described as “unusually large” leads one to include them. Answer (d) is incorrect because an auditor will not draw numerous samples to assure inclusion of the large disbursements.

41. (b) The requirement is to determine whether either or both of the expected amount of misstatement and the measure of tolerable misstatement influence sample size for a substantive test of details. Answer (b) is correct because both the expected amount of misstatement and the tolerable misstatement affect sample size (AICPA Audit Sampling Guide). Increases in the expected amount of misstatements increase sample size, while increases in the tolerable misstatement decrease sample size.

42. (c) The requirement is to determine the correct statement concerning the auditor’s consideration of tolerable misstatement. Answer (c) is correct because the consideration of tolerable misstatement is related to preliminary judgments in a manner such that when the auditor’s preliminary judgments about tolerable misstatement levels for accounts or transaction types are combined for the entire audit plan, the preliminary judgments about materiality levels for the financial statements are not exceeded. Answer (a) is incorrect because the auditor’s judgment of business risk related to a client is not directly related to tolerable misstatement. Answer (b) is incorrect because tolerable misstatement may be adjusted for qualitative factors. Answer (d) is incorrect because tolerable misstatement may be changed during the audit process, especially as misstatements are identified and the auditor considers the nature of the misstatements.

43. (d) The requirement is to determine the factor that would lead to larger sample size in a substantive test of details. Answer (d) is correct because the sample size required to achieve the auditor’s objective at a given risk of incorrect acceptance increases as the auditor’s assessment of tolerable misstatement for the balance or class decreases. Answer (a) is incorrect because a greater reliance on internal control will lead to a smaller sample size in a substantive test of details. Answer (b) is incorrect because greater reliance upon analytical procedures will result in a need for less reliance on substantive tests of details and therefore will result in a smaller sample. Answer (c) is incorrect because a smaller expected frequency of errors will generally include properly functioning

internal control and will therefore result in a smaller sample for substantive tests of details.

44. (c) The requirement is to identify the factor which must be known in order to estimate the appropriate sample size when using variables sampling. Answer (c) is correct because the auditor must set an acceptable level of risk for both variables sampling and attribute sampling. Answer (a) is incorrect because while the auditor will consider the qualitative aspects of errors when evaluating the sample, they need not be considered in determining an appropriate sample size. Answer (b) is incorrect because a primary objective of variables sampling is to estimate the audited dollar amount of the population. Also, in some forms of variables sampling, knowledge of book values is not necessary (e.g., mean-per-unit). Answer (d) is incorrect because a rate of error in the population relates to attribute sampling.

45. (a) The requirement is to identify an auditor's **most** likely response to a circumstance in which there is a tolerable misstatement of \$60,000, and the auditor has discovered misstatement of a net overstatement of \$3,500 (\$3,700 – \$200) when 1/20 of the account has been included in the sample. Because auditors must project the misstatements to the entire population, one would expect a misstatement of approximately \$70,000 (20 times the misstatement of \$3,500). Since this exceeds the tolerable misstatement, there is little question that the risk of material misstatement is too high and that the misstatement in the population exceeds the tolerable misstatement, therefore answer (a) is correct. Answer (b) is incorrect because it seems that the sum of actual overstatement and understatement is likely to exceed the tolerable misstatement. Also, answer (b) makes little sense since there probably is no such thing as “an unacceptably high risk” that the tolerable misstatement exceeds the sum of actual overstatements and understatements; in such a circumstance the auditor simply accepts the population as being materially correct. Answers (c) and (d) are incorrect because the total projected misstatement must be calculated as indicated above. See AU-C 530 and the Audit Sampling Guide for information on sampling.

46. (c) The requirement is to identify the correct statement regarding probability-proportional-to-size (PPS) sampling. Answer (c) is correct because when using PPS sampling, the auditor controls the risk of incorrect acceptance by specifying a risk level when planning the sample. Answer (a) is incorrect because PPS sampling does not assume a normal distribution. Answer (b) is incorrect because the book value of the unit determines how probable it is that it will be included in the sample, not whether it is over or understated. Answer (d) is incorrect because the sampling interval is calculated by dividing the book value of the population by the sample size.

47. (d) The requirement is to determine the sample size that should be used in a probability-proportional-to-size (PPS) sample. One approach is to first calculate a sampling interval and use it to determine an appropriate sample size. Using this approach, when provided with the tolerable misstatement already adjusted for expected misstatements (as is the situation in this problem), one divides that total by the number of

expected misstatements column for the appropriate risk of incorrect acceptance (the fact that some overstatements are expected is not used). Here that computation is $\$24,000/1.61 = \$14,906.83$. Sample size is computed by dividing the recorded amount by the sampling interval, here $\$240,000/\$14,906.83$, for a sample size of 16. An alternate approach is to use the reliability factor for the expected number of overstatements. In that case the computations become $\$24,000/3.00 = \$8,000$. Sample size is $\$240,000/\$8,000 = 30$. In either case answer (d) is the closest and therefore the correct reply.

48. (b) The requirement is to determine the projected error (misstatement) of a probability-proportional-to-size (PPS) sample with a sampling interval of \$5,000, when an auditor has discovered that an account with a recorded amount of \$10,000 had an audit amount of \$8,000. Answer (b) is correct since, when an account's recorded amount exceeds the sampling interval, the projected error equals the actual misstatement, here \$2,000 ($\$10,000 - \$8,000$).

49. (a) The requirement is to determine whether an auditor uses the variability in dollar values, the risk of incorrect acceptance, or both, in a mean-per-unit estimation variables sampling plan. Answer (a) is correct because both factors are included in a sampling plan. Answers (b), (c), and (d) are all incorrect because they suggest that one or both factors are not considered. See AU-C 530 and the AICPA Audit Sampling Guide for information on sampling.

50. (b) The requirement is to identify the circumstance in which an auditor **most** likely would stratify a population into meaningful groups. Answer (b) is correct because stratified sampling is used to minimize the effect on sample size of variation within the overall population and results in the largest savings for populations with high variability. Answer (a) is incorrect because while PPS sampling may in essence stratify a population, the items selected, other than those larger than the sampling interval, are not in “meaningful groups.” Answer (c) is incorrect because the tolerable misstatement in and of itself will not lead to stratification. Answer (d) is incorrect because stratification is used primarily when there is a relatively large standard deviation, not a relatively small standard deviation.

51. (a) The requirement is to determine when ratio estimation sampling is most effective. The ratio estimation sampling technique uses the ratio between the audited to book amounts as a measure of standard deviation in its sample size computation. Answer (a) is correct because when audit differences are approximately proportional to account size the standard deviation of the ratio is small and this results in a relatively small required sample size. Answer (b) is incorrect because a relatively large number of differences between book and audited values must exist to calculate a reliable standard deviation under the ratio method. Answer (c) is incorrect because while the ratio estimation sampling technique may be used with quantities, it offers no particular advantage over other methods. Answer (d) is incorrect because the absolute size of differences does not make the ratio estimation method most effective.

52. (a) The requirement is to determine the purpose of taking a preliminary sample when one uses statistical techniques. It is necessary to obtain an estimate of a population's standard deviation (variability) when calculating the required sample size and when using sampling techniques. Answers (b), (c), and (d) are incorrect because, in most statistical techniques used by auditors, the mode (most frequent balance), the median (middle balance) and the range (difference between the highest and lowest values) are not used.

53. (b) The requirement is to determine the estimated audited accounts payable balance using the ratio estimation technique. Answer (b) is correct because the ratio estimation technique estimates the audited value by multiplying the audited value/book value of the sample times the population book value. In this case, $(\$300,000/\$250,000) \times \$5,000,000 = \$6,000,000$.

54. (b) The ratio estimation sampling technique is based on comparing the ratio of the book value to the audited value of the sampled items. Answer (b) is correct because this method cannot be used when there is no book value to make the comparison. The circumstances described in answers (a) and (c) are necessary for ratio point and interval estimation. Answer (d) describes the circumstances in which the use of ratio estimation will be efficient in terms of required sample size.

55. (d) The requirement is to determine the most appropriate sampling approach for substantive tests of pricing and extensions of perpetual inventory balances consisting of a large number of items for which past experience indicates numerous expected pricing and extension errors. Answer (d) is correct because ratio estimation is appropriate when testing a population for which a large number of errors of this nature is expected (Audit and Accounting Guide, Audit Sampling). Answer (a) is incorrect because the unstratified mean-per-unit method will typically provide a larger sample size than the ratio estimation method to achieve the same level of sampling risk. Thus, the ratio estimation method would be more appropriate. Answer (b) is incorrect because probability-proportional-to-size sampling is most efficient for testing populations with relatively low expected error rates. Answer (c) is incorrect because "stop or go" or "sequential" sampling is most frequently used in attribute sampling.

56. (d) Difference and ratio estimation methods are statistical sampling methods. They measure the difference between audit and book values or the ratio of audit to book values. As

these differences should not be great, the population of these differences will have little variance. In statistical sampling, the less variation in a population, the smaller the required sample to provide an estimate of the population. In other words, difference and ratio estimation methods are more efficient because the differences between audit and book values are expected to vary less than the actual items in the population.

Answer (a) is incorrect because the number of members in the population for differences or ratio methods would be the same as the number of items in the population for a direct estimation method. In difference sampling, many items would be zero because audit and book are the same, and in ratio sampling, many of the members would be one for the same reason.

Answer (b) is incorrect because beta risk can never be ignored, as beta risk is the risk of accepting an incorrect (unacceptable) population. Answer (c) is incorrect because the calculations required in difference and ratio sampling are similar to those used in direct estimation sampling.

57. (a) The requirement is to identify the correct statement concerning the auditor's use of statistical sampling. Answer (a) is correct because an estimate of the variation of the population, the standard deviation, is needed to use classical variables sampling (AICPA Audit and Accounting Guide, Audit Sampling). Answer (b) is incorrect because PPS sampling does not make an assumption that the underlying population is normally distributed. Answers (c) and (d) are incorrect because classical variables sample selected accounts and therefore need not include special considerations to those with a negative balance.

58. (c) The requirement is to identify an advantage in using classical variables sampling rather than probability-proportional-to-size sampling. Answer (c) is correct because the inclusion of zero and negative balances generally does **not** require special design considerations when using classical sampling, while it does when using probability-proportional-to-size sampling (AICPA Audit Sampling Guide). Answer (a) is incorrect because classical variables sampling does require an estimate of the standard deviation of the population's recorded amounts. Answer (b) is incorrect because the computational process involved with classical variables sampling may make use of a computer program desirable. Answer (d) is incorrect because probability-proportional-to-size sampling, not classical sampling, automatically stratifies individually significant items.

Multiple-Choice Questions (1–32)

A. *The Auditor's Consideration of Internal Control When a Computer Is Present*

1. An advantage of using systems flowcharts to document information about internal control instead of using internal control questionnaires is that systems flowcharts
 - a. Identify internal control weaknesses more prominently.
 - b. Provide a visual depiction of clients' activities.
 - c. Indicate whether control procedures are operating effectively.
 - d. Reduce the need to observe clients' employees performing routine tasks.
2. A flowchart is most frequently used by an auditor in connection with the
 - a. Preparation of generalized computer audit plans.
 - b. Review of the client's internal control.
 - c. Use of statistical sampling in performing an audit.
 - d. Performance of analytical procedures of account balances.
3. Matthews Corp. has changed from a system of recording time worked on clock cards to a computerized payroll system in which employees record time in and out with magnetic cards. The computer system automatically updates all payroll records. Because of this change
 - a. A generalized computer audit program must be used.
 - b. Part of the audit trail is altered.
 - c. The potential for payroll-related fraud is diminished.
 - d. Transactions must be processed in batches.
4. Which of the following is correct concerning batch processing of transactions?
 - a. Transactions are processed in the order they occur, regardless of type.
 - b. It has largely been replaced by online real-time processing in all but legacy systems.
 - c. It is more likely to result in an easy-to-follow audit trail than is online transaction processing.
 - d. It is used only in non-database applications.
5. An auditor would be **most** likely to assess control risk at the maximum level in an electronic environment with automated system-generated information when
 - a. Sales orders are initiated using predetermined, automated decision rules.
 - b. Payables are based on many transactions and large in dollar amount.
 - c. Fixed asset transactions are few in number, but large in dollar amount.
 - d. Accounts receivable records are based on many transactions and are large in dollar amount.
6. In a highly automated information processing system tests of control
 - a. Must be performed in all circumstances.
 - b. May be required in some circumstances.
 - c. Are never required.
 - d. Are required in first year audits.
7. Which of the following is **least** likely to be considered by an auditor considering engagement of an information technology (IT) specialist on an audit?
 - a. Complexity of client's systems and IT controls.
 - b. Requirements to assess going concern status.
 - c. Client's use of emerging technologies.
 - d. Extent of entity's participation in electronic commerce.
8. Which of the following strategies would a CPA **most** likely consider in auditing an entity that processes most of its financial data only in electronic form, such as a paperless system?
 - a. Continuous monitoring and analysis of transaction processing with an embedded audit module.
 - b. Increased reliance on internal control activities that emphasize the segregation of duties.
 - c. Verification of encrypted digital certificates used to monitor the authorization of transactions.
 - d. Extensive testing of firewall boundaries that restrict the recording of outside network traffic.
9. Which of the following is **not** a major reason for maintaining an audit trail for a computer system?
 - a. Deterrent to fraud.
 - b. Monitoring purposes.
 - c. Analytical procedures.
 - d. Query answering.
10. Computer systems are typically supported by a variety of utility software packages that are important to an auditor because they
 - a. May enable unauthorized changes to data files if not properly controlled.
 - b. Are very versatile programs that can be used on hardware of many manufacturers.
 - c. May be significant components of a client's application programs.
 - d. Are written specifically to enable auditors to extract and sort data.

11. An auditor would **most** likely be concerned with which of the following controls in a distributed data processing system?

- a. Hardware controls.
- b. Systems documentation controls.
- c. Access controls.
- d. Disaster recovery controls.

12. Which of the following types of evidence would an auditor **most** likely examine to determine whether internal control is operating as designed?

- a. Gross margin information regarding the client's industry.
- b. Confirmations of receivables verifying account balances.
- c. Client records documenting the use of computer programs.
- d. Anticipated results documented in budgets or forecasts.

13. An auditor anticipates assessing control risk at a low level in a computerized environment. Under these circumstances, on which of the following activities would the auditor initially focus?

- a. Programmed control activities.
- b. Application control activities.
- c. Output control activities.
- d. General control activities.

14. After the preliminary phase of the review of a client's computer controls, an auditor may decide not to perform tests of controls related to the controls within the computer portion of the client's internal control. Which of the following would **not** be a valid reason for choosing to omit such tests?

- a. The controls duplicate operative controls existing elsewhere in the structure.
- b. There appear to be major weaknesses that would preclude reliance on the stated procedure.
- c. The time and dollar costs of testing exceed the time and dollar savings in substantive testing if the tests of controls show the controls to be operative.
- d. The controls appear adequate.

15. Auditing by testing the input and output of a computer system instead of the computer program itself will

- a. Not detect program errors which do **not** show up in the output sampled.
- b. Detect all program errors, regardless of the nature of the output.
- c. Provide the auditor with the same type of evidence as tests of application controls.
- d. Not provide the auditor with confidence in the results of the auditing procedures.

16. Which of the following client information technology (IT) systems generally can be audited without examining or directly testing the IT computer programs of the system?

- a. A system that performs relatively uncomplicated processes and produces detailed output.

- b. A system that affects a number of essential master files and produces a limited output.
- c. A system that updates a few essential master files and produces no printed output other than final balances.
- d. A system that performs relatively complicated processing and produces very little detailed output.

17. An auditor who wishes to capture an entity's data as transactions are processed and continuously test the entity's computerized information system **most** likely would use which of the following techniques?

- a. Snapshot application.
- b. Embedded audit module.
- c. Integrated data check.
- d. Test data generator.

18. Which of the following computer-assisted auditing techniques processes client input data on a controlled program under the auditor's control to test controls in the computer system?

- a. Test data.
- b. Review of program logic.
- c. Integrated test facility.
- d. Parallel simulation.

B. Computerized Audit Tools

19. To obtain evidence that online access controls are properly functioning, an auditor **most** likely would

- a. Create checkpoints at periodic intervals after live data processing to test for unauthorized use of the system.
- b. Examine the transaction log to discover whether any transactions were lost or entered twice due to a system malfunction.
- c. Enter invalid identification numbers or passwords to ascertain whether the system rejects them.
- d. Vouch a random sample of processed transactions to assure proper authorization.

20. An auditor **most** likely would introduce test data into a computerized payroll system to test controls related to the

- a. Existence of unclaimed payroll checks held by supervisors.
- b. Early cashing of payroll checks by employees.
- c. Discovery of invalid employee I.D. numbers.
- d. Proper approval of overtime by supervisors.

21. When an auditor tests a computerized accounting system, which of the following is true of the test data approach?

- a. Several transactions of each type must be tested.
- b. Test data are processed by the client's computer programs under the auditor's control.
- c. Test data must consist of all possible valid and invalid conditions.
- d. The program tested is different from the program used throughout the year by the client.

22. Which of the following is **not** among the errors that an auditor might include in the test data when auditing a client's computer system?

- a. Numeric characters in alphanumeric fields.
- b. Authorized code.
- c. Differences in description of units of measure.
- d. Illogical entries in fields whose logic is tested by programmed consistency checks.

23. Which of the following computer-assisted auditing techniques allows fictitious and real transactions to be processed together without client operating personnel being aware of the testing process?

- a. Integrated test facility.
- b. Input controls matrix.
- c. Parallel simulation.
- d. Data entry monitor.

24. Which of the following methods of testing application controls utilizes a generalized audit software package prepared by the auditors?

- a. Parallel simulation.
- b. Integrated testing facility approach.
- c. Test data approach.
- d. Exception report tests.

25. In creating lead schedules for an audit engagement, a CPA often uses automated workpaper software. What client information is needed to begin this process?

- a. Interim financial information such as third quarter sales, net income, and inventory and receivables balances.
- b. Specialized journal information such as the invoice and purchase order numbers of the last few sales and purchases of the year.
- c. General ledger information such as account numbers, prior year account balances, and current year unadjusted information.
- d. Adjusting entry information such as deferrals and accruals, and reclassification journal entries.

26. Using laptop computers in auditing may affect the methods used to review the work of staff assistants because

- a. The generally accepted auditing standards may differ.
- b. Documenting the supervisory review may require assistance of consulting services personnel.
- c. Supervisory personnel may **not** have an understanding of the capabilities and limitations of laptops.
- d. Working paper documentation may not contain readily observable details of calculations.

27. An auditor would **least** likely use computer software to

- a. Access client data files.
- b. Prepare spreadsheets.
- c. Assess computer control risk.
- d. Construct parallel simulations.

28. A primary advantage of using generalized audit software packages to audit the financial statements of a client that uses a computer system is that the auditor may

- a. Access information stored on computer files while having a limited understanding of the client's hardware and software features.
- b. Consider increasing the use of substantive tests of transactions in place of analytical procedures.
- c. Substantiate the accuracy of data through self-checking digits and hash totals.
- d. Reduce the level of required tests of controls to a relatively small amount.

29. Auditors often make use of computer programs that perform routine processing functions such as sorting and merging. These programs are made available by electronic data processing companies and others and are specifically referred to as

- a. Compiler programs.
- b. Supervisory programs.
- c. Utility programs.
- d. User programs.

30. Smith Corporation has numerous customers. A customer file is kept on disk storage. Each customer file contains name, address, credit limit, and account balance. The auditor wishes to test this file to determine whether credit limits are being exceeded. The **best** procedure for the auditor to follow would be to

- a. Develop test data that would cause some account balances to exceed the credit limit and determine if the system properly detects such situations.
- b. Develop a program to compare credit limits with account balances and print out the details of any account with a balance exceeding its credit limit.
- c. Request a printout of all account balances so they can be manually checked against the credit limits.
- d. Request a printout of a sample of account balances so they can be individually checked against the credit limits.

31. An auditor **most** likely would test for the presence of unauthorized computer program changes by running a

- a. Program with test data.
- b. Check digit verification program.
- c. Source code comparison program.
- d. Program that computes control totals.

32. An entity has the following invoices in a batch:

Invoice #	Product	Quantity	Unit price
201	F10	150	\$5.00
202	G15	200	\$10.00
203	H20	250	\$25.00
204	K35	300	\$30.00

Which of the following numbers represents the record count?

- a. 1
- b. 4
- c. 810
- d. 900

Multiple-Choice Answers and Explanations

Answers

1. b ___	7. b ___	13. d ___	19. c ___	25. c ___	31. c ___
2. b ___	8. a ___	14. d ___	20. c ___	26. d ___	32. b ___
3. b ___	9. c ___	15. a ___	21. b ___	27. c ___	
4. c ___	10. a ___	16. a ___	22. a ___	28. a ___	
5. c ___	11. c ___	17. b ___	23. a ___	29. c ___	1st: ___/32 = ___%
6. b ___	12. c ___	18. d ___	24. a ___	30. b ___	2nd: ___/32 = ___%

Explanations

1. (b) The requirement is to identify an advantage of using systems flowcharts to document information about internal control instead of using internal control questionnaires. Answer (b) is correct because flowcharts provide a visual depiction of clients' activities which make it possible for auditors to quickly understand the design of the system. Answer (a) is incorrect because while the flow of operations is visually depicted, internal control weaknesses are not as obvious. Answer (c) is incorrect because while a flowchart describes a system, the flowchart alone does not indicate whether that system is operating effectively. Answer (d) is incorrect because auditors still need to determine whether the system has been placed in operation and therefore the need to observe employees performing routine tasks remains.
2. (b) The requirement is to determine when a flowchart is **most** frequently used by an auditor. Answer (b) is correct because flowcharts are suggested as being appropriate for documenting the auditor's consideration of internal control. Answer (a) is incorrect because auditors do not frequently write their own generalized computer audit programs, the most likely time a flowchart would be used with respect to such software. Answers (c) and (d) are incorrect because statistical sampling and analytical procedures do not in general require the use of flowcharts.
3. (b) The requirement is to identify the correct statement with respect to a computerized, automatically updating payroll system in which magnetic cards are used instead of a manual payroll system with clock cards. Answer (b) is correct because the automatic updating of payroll records alters the audit trail which, in the past, included steps pertaining to manual updating. Answer (a) is incorrect because although an auditor may choose to use a generalized computer audit program, it is not required. Answer (c) is incorrect because no information is presented that would necessarily indicate a change in the likelihood of fraud. Answer (d) is incorrect because given automatic updating, a large portion of the transactions are not processed in batches.
4. (c) The requirement is to identify the correct statement concerning the batch processing of transactions. Batch processing involves processing transactions through the system in groups of like transactions (batches). Answer (c) is correct because the similar nature of transactions involved with batch processing ordinarily makes it relatively easy to follow the transactions throughout the system. Answer (a) is incorrect

because transactions are processed by type, not in the order they occur regardless of type. Answer (b) is incorrect because many batch applications still exist and might be expected to exist well into the future. Answer (d) is incorrect because batch processing may be used for database applications.

5. (c) The requirement is to determine when an auditor would be **most** likely to assess control risk at the maximum level in an electronic environment with automated system-generated information. Answer (c) is correct because the few transactions involved in fixed assets make it most likely to be one in which a substantive approach of restricting detection risk is most likely to be effective and efficient. Answer (a) is incorrect because an auditor might be expected to perform tests of controls to assess control risk below the maximum when automated decision rules are involved for an account (sales) which ordinarily has many transactions. Answers (b) and (d) are incorrect because the numerous transactions in payables and receivables make it likely that control risk will be assessed below the maximum.

6. (b) The requirement is to identify the most accurate statement with respect to tests of controls of a highly automated information processing system. Answer (b) is correct because in some such circumstances substantive tests alone will not be sufficient to restrict detection risk to an acceptable level. Answer (a) is incorrect because tests of controls need not be performed in all such circumstances. Answer (c) is incorrect because such tests are sometimes required. Answer (d) is incorrect because tests of controls are not in such circumstances in all first year audits.

7. (b) The requirement is to identify the **least** likely circumstance in which an auditor would consider engagements of an IT specialist on an audit. Answer (b) is correct because the requirement to assess going concern status remains the same on all audits, and thus does not directly affect engagement of an IT specialist. Answers (a), (c), and (d) are all incorrect because complexity, the use of emerging technologies, and participation in electronic commerce are all factors which make it more likely that an IT specialist will be engaged.

8. (a) The requirement is to identify a strategy that a CPA **most** likely would consider in auditing an entity that processes most of its financial data only in electronic form. Answer (a) is correct because continuous monitoring and analysis of transaction processing with an embedded audit module

might provide an effective way of auditing these processes—although some question exists as to how many embedded audit modules CPAs have actually used in practice. Answer (b) is incorrect because there may well be a decrease in reliance on internal control activities that emphasize this segregation of duties since so many controls are in the hardware and software of the application. Answer (c) is incorrect because digital certificates deal with electronic commerce between companies, a topic not directly addressed by this question, and because such certificates provide limited evidence on authorization. Answer (d) is incorrect because while firewalls do control network traffic, this is not the most significant factor in the audit of electronic form financial data.

9. (c) The requirement is to identify the reply that is **not** a major reason for maintaining an audit trail for a computer system. Answer (c) is correct because analytical procedures use the outputs of the system, and therefore the audit trail is of limited importance. Answer (a) is incorrect because an audit trail may deter fraud since the perpetrator may realize that his or her act may be detected. Answer (b) is incorrect because an audit trail will help management to monitor the computer system. Answer (d) is incorrect because an audit trail will make it much easier to answer queries.

10. (a) The requirement is to identify a reason that utility software packages are important to an auditor. Answer (a) is correct because client use of such packages requires that the auditor include tests to determine that no unplanned interventions using utility routines have taken place during processing (Audit and Accounting Guide, Computer Assisted Audit Techniques). Answer (b) is incorrect because a client's use of such programs implies that they are useful on his/her computer hardware, and therefore any flexibility is not of immediate relevance to the auditor. Answer (c) is incorrect because the primary purpose of utility programs is to support the computer user's applications (Computer Assisted Audit Techniques). Answer (d) is incorrect because utility software programs have a variety of uses in addition to enabling auditors to extract and sort data (Computer Assisted Audit Techniques).

11. (c) The requirement is to identify the types of controls with which an auditor would be **most** likely to be concerned in a distributed data processing system. A distributed data processing system is one in which there is a network of remote computer sites, each having a computer connected to the main computer system, thus allowing access to the computers by various levels of users. Accordingly, answer (c) is correct because numerous individuals may access the system, thereby making such controls of extreme importance. Answers (a), (b), and (d), while requiring concern, are normally considered less critical than proper access controls for this situation.

12. (c) The requirement is to identify the type of evidence an auditor would examine to determine whether internal control is operating as designed. Answer (c) is correct because the inspection of documents and records such as those related to computer programs represents an approach for obtaining an understanding of internal control. Answer (a) is incorrect because examining gross margin information is more likely to be performed during the performance of analytical procedures.

Answer (b) is incorrect because confirming of receivables is a substantive test. Answer (d) is incorrect because anticipated results documented in budgets or forecasts are much more frequently used in the performance of analytical procedures.

13. (d) The requirement is to determine the procedures on which the auditor would initially focus when anticipating assessing control risk at a low level. Answer (d) is correct because auditors usually begin by considering general control procedures. Since the effectiveness of specific application controls is often dependent on the existence of effective general controls over all computer activities, this is usually an efficient approach. Answers (a), (b), and (c) are all incorrect because they represent controls that are usually tested subsequent to the general controls.

14. (d) The requirement is to determine an **inappropriate** reason for omitting tests of controls related to computer control procedures. Answer (d) is correct because the fact that the controls **appear** adequate is not sufficient justification for reliance; tests of controls must be performed before the auditor can actually rely upon a control procedure to reduce control risk. Answer (a) is incorrect because when controls duplicate other controls the auditor who wishes to rely upon internal control need not test both sets. Answer (b) is incorrect because if weak controls are not to be relied upon, the auditor need not test their effectiveness. Answer (c) is incorrect because tests of controls may be omitted if their cost exceeds the savings from reduced substantive testing resulting from reliance upon the controls.

15. (a) The requirement is to determine the correct statement with respect to testing inputs and outputs of a computer system instead of testing the actual computer program itself. Answer (a) is correct because portions of the program which have errors not reflected on the output will be missed. Thus, if a "loop" in a program is not used in one application, it is not tested. Answer (b) is incorrect because the lack of an understanding of the entire program precludes the detection of all errors. Answer (c) is incorrect because while auditing inputs and outputs can provide valuable evidence, it will often be different than the evidence obtained by testing the program itself. Answer (d) is incorrect because such auditing of inputs and outputs may well satisfy the auditor.

16. (a) The requirement is to identify the type of computer system that can be audited without examining or directly testing computer programs (i.e., auditing around the system). Auditing around the system is possible if the system performs uncomplicated processes and produces detailed output (i.e., is a fancy bookkeeping machine). Answers (b), (c), and (d) all describe more complicated computer systems that produce only limited output. In these more complicated systems, the data and related controls are within the system, and thus the auditor must examine the system itself. Auditors must identify and evaluate the accounting controls in all computer systems. Further, complex computer systems require auditor specialized expertise to perform the necessary procedures.

17. (b) The requirement is to determine an audit technique to determine whether an entity's transactions are processed and to continuously test the computerized information system.

Answer (b) is correct because an embedded audit module is inserted within the client's information system to continuously test the processing of transactions. Answer (a) is incorrect because a snapshot application analyzes the information system at one point in time. Answer (c) is incorrect because an integrated data check simply tests data at one point in time. Answer (d) is incorrect because a test data generator provides a sample of possible circumstances in which data might be improperly processed.

18. (d) The requirement is to identify the computer-assisted audit technique that processes client input data on a controlled program under the auditor's control to test controls in a computer system. Answer (d) is correct because parallel simulation processes actual client data through an auditor's generalized audit software program. Answer (a) is incorrect because test data is a set of dummy transactions developed by the auditor and processed by the client's programs to determine whether the controls which the auditor intends to test are operating effectively. Answer (b) is incorrect because a review of program logic is an approach in which an auditor reviews the steps by which the client's program processes data. Answer (c) is incorrect because an integrated test facility introduces dummy transactions into a client's system in the midst of live transactions.

19. (c) The requirement is to determine the **best** way to obtain evidence that on-line access controls are properly functioning. Answer (c) is correct because entering invalid identification numbers or passwords will provide the auditor with evidence on whether controls are operating as designed. Answer (a) is incorrect because directly testing access controls is more direct than testing data through checkpoints at intervals. Answer (b) is incorrect because a transaction log will not in general, by itself, identify whether transactions were lost or entered twice. Answer (d) is incorrect because vouching proper authorization is only one measure of whether controls are properly functioning.

20. (c) The requirement is to identify the situation in which it is **most** likely that an auditor would introduce test data into a computerized payroll system. Test data is a set of dummy transactions developed by the auditor and processed by the client's computer programs. These dummy transactions are used to determine whether the controls which the auditor tests are operating effectively. Answer (c) is correct because test data with invalid employee I.D. numbers could be processed to test whether the program detects them. Answer (a) is incorrect because the unclaimed payroll checks are held by the supervisors and no testing of the computer program is involved. Answer (b) is incorrect because no computer processing is generally involved when payroll checks are "cashied early" by employees. Answer (d) is incorrect because to test whether the approval of overtime is proper, one must determine what criteria are used for the decision and must then determine whether supervisors are following those criteria; it is less likely that this will all be included in a computer program than a test for invalid employee ID numbers.

21. (b) The requirement is to identify the correct statement regarding the test data approach. Answer (b) is correct because the test data approach consists of processing a set of

dummy transactions on the client's computer system. The test data approach is used to test the operating effectiveness of controls the auditor intends to rely upon to assess control risk at a level lower than the maximum. Answer (a) is incorrect because only one transaction of each type is generally tested. Answer (c) is incorrect because it is not possible to include **all** possible valid and invalid conditions. Answer (d) is incorrect because the program that should be tested is the client's program which is used throughout the year.

22. (a) The requirement is to determine which reply is **not** among the errors which are generally detected by test data. An auditor uses test data to determine whether purported controls are actually functioning. Answer (a) is correct because one would not use test data to test numeric characters in alphanumeric fields; numeric characters are accepted in alphanumeric fields and thus do not represent error conditions. Answer (b) is incorrect because authorization codes may be tested by inputting inappropriate codes. Answer (c) is incorrect because differing descriptions of units of measure may be inputted to test whether they are accepted. Answer (d) is incorrect because illogical combinations may be inputted to test whether they are detected by the system.

23. (a) The requirement is to identify the computer-assisted auditing technique which allows fictitious and real transactions to be processed together without client operating personnel being aware of the testing process. Answer (a) is correct because the integrated test facility approach introduces dummy transactions into a system in the midst of live transactions. Accordingly, client operating personnel may not be aware of the testing process. Answer (b) is incorrect because an input control matrix would simply indicate various controls in the form of a matrix. Answer (c) is incorrect because the parallel simulation technique requires the processing of actual client data through an auditor's software program. In this case, the client would be aware of the testing process since the auditor would need to request copies of data run on the actual system so that the data could then be run on the auditor's software program. Additionally, only valid transactions would be tested under parallel simulation. Answer (d) is incorrect because the client would generally be aware of an auditor using a data entry monitor (screen) to input transactions.

24. (a) The requirement is to determine the auditing technique which utilizes generalized audit software. Answer (a) is correct because the parallel simulation method processes the client's data using the CPA's software. Answers (b) and (c) are incorrect because the client's hardware and software are tested using test data designed by the CPA. Answer (d) is incorrect because although a CPA may test a client's exception reports in various manners, generalized software is unlikely to be used. Exception reports are generally tested via CPA-prepared test data containing all the possible error conditions. The test data are then run on the client's hardware and software to ascertain whether the exception reports are "picking up" the CPA's test data.

25. (c) The requirement is to identify the information that must be available to begin creating automated lead schedules. A lead schedule is used to summarize like accounts (e.g., if a client has five cash accounts those

accounts may be summarized on a lead schedule). Answer (c) is correct because lead schedules include information such as account numbers, prior year account balances, and current year unadjusted information. Answer (a) is incorrect because interim information is not necessary. Answer (b) is incorrect because invoice and purchase order numbers are not summarized on lead schedules. Answer (d) is incorrect because adjusting entry information is identified subsequent to the creation of lead schedules.

26. (d) The requirement is to identify an effect on audit work review methods of using laptop computers in auditing. Answer (d) is correct because laptops typically produce a number of the “working papers” in computer disk form and because many computations, etc. will be performed directly by the computer with few details of the calculations conveniently available. Answer (a) is incorrect because the generally accepted auditing standards remain the same regardless of whether or not computers are being utilized. Answer (b) is incorrect because one would not normally expect consulting services personnel to help with documentation. Answer (c) is incorrect because supervisory personnel must have an understanding of the capability and limitations of laptops before they are utilized on audits.

27. (c) The requirement is to determine an auditor’s **least** likely use of computer software. Answer (c) is correct because an auditor will judgmentally assess control risk related to both the computer and manual systems after having performed the various tests of controls. Answer (a) is incorrect because computer software will be used to access client data files. Answers (b) and (d) are incorrect because software is used to prepare spreadsheets and to perform parallel simulations.

28. (a) The requirement is to identify a primary advantage of using generalized audit software packages to audit the financial statements of a client that uses a computer system. Answer (a) is correct because generalized audit software allows an auditor to perform audits tests on a client’s computer files. Answer (b) is incorrect because generalized audit software packages may assist the auditor with either substantive tests of transactions or analytical procedures. Answer (c) is incorrect because while generalized audit software might be used to perform such operations, this is not their primary advantage. Answer (d) is incorrect because generalized audit software packages have no direct relationship to the performance of tests of controls.

29. (c) The requirement is to determine the type of computer programs which auditors use to assist them in functions such as sorting and merging. Answer (c) is correct because a

utility program is a standard routine for performing commonly required processing such as sorting, merging, editing, and mathematical routines. Answer (a) is incorrect because compiler programs translate programming languages such as COBOL or FORTRAN to machine language. Answer (b) is incorrect because supervisory programs or “operating systems” consist of a series of programs that perform functions such as scheduling and supervising the application programs, allocating storage, controlling peripheral devices, and handling errors and restarts. Answer (d) is incorrect because user or “application programs” perform specific data processing tasks such as general ledger, accounts payable, accounts receivable, and payroll. Application programs make use of utility routines.

30. (b) The requirement is to determine the **best** approach for determining whether credit limits **are being exceeded** when accounts receivable information is stored on disk. Answer (b) is correct because a program to compare actual account balances with the predetermined credit limit and thereby prepare a report on whether any actual credit limits are being exceeded will accomplish the stated objective. Answer (a) is incorrect because while test data will indicate whether the client’s program **allows** credit limits to be exceeded, it will not indicate whether credit limits **are actually being exceeded**. Answer (c) is incorrect because a manual check of all account balances will be very time consuming. Answer (d) is incorrect because a sample will provide less complete information than the audit of the entire population which is indicated in answer (b).

31. (c) The requirement is to identify how an auditor would test for the presence of unauthorized computer program changes. Answer (c) is correct because comparing source code of the program with a correct version of the program will disclose unauthorized computer program changes. Answer (a) is incorrect because test data is generally used to test specific controls and it will generally be less effective for detecting unauthorized changes than will source code comparison. Answer (b) is incorrect because check digits are primarily used as an input control to determine that input data is proper. Answer (d) is incorrect because properly computing control totals is only one possible unauthorized change that might be made to a program.

32. (b) The requirement is to identify the number that represents the record count. Answer (b) is correct because the record count represents the number of records in a file, in this case 4.

Appendix B: Auditing and Attestation Sample Examination

Testlet 1

1. Which of the following is ordinarily considered to be a fraud risk factor?

- a. The company's financial statements include a number of last minute material adjustments.
- b. Management regularly informs investors of forecast information.
- c. The company has experienced increasing earnings over the previous five years.
- d. The company's president is included as a member of the board of directors.

2. Which of the following statements **best** describes the primary purpose of Statements on Auditing Standards?

- a. They are guides intended to set forth auditing procedures that are applicable to a variety of situations.
- b. They are procedural outlines that are intended to narrow the areas of inconsistency and divergence of auditor opinion.
- c. They are authoritative statements, enforced through the Code of Professional Conduct.
- d. They are interpretive guidance.

3. Independence is required for which of the following types of engagements?

	Agreed-upon procedures	Review
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

4. Which of the following should an auditor obtain from the predecessor auditor prior to accepting an audit engagement?

- a. Analysis of balance sheet accounts.
- b. Analysis of income statement accounts.
- c. All matters of continuing accounting significance.
- d. Facts that might bear on the integrity of management.

5. Which of the following is correct concerning allowing additions and deletions to audit documentation after the documentation completion date under requirements of the Public Company Accounting Oversight Board?

	Additions	Deletions
a.	Allowed	Allowed
b.	Allowed	Not allowed
c.	Not allowed	Allowed
d.	Not allowed	Not allowed

6. One reason that an auditor only obtains reasonable, and not absolute, assurance that financial statements are free from material misstatement is

- a. Comprehensive basis reporting.

- b. Employee collusion.
- c. Material misstatements.
- d. Professional skepticism.

7. The auditors of a nonissuer (nonpublic) company must perform a test of the operating effectiveness of a significant control

- a. In all audits.
- b. When the control relates to a significant asset.
- c. When substantive procedures alone will not provide sufficient evidence about the related assertion.
- d. When the auditors believe that the control may not be effective.

8. The independent auditor selects several transactions in each functional area and traces them through the entire system, paying special attention to evidence about whether or not the controls are in operation. This is an example of a(n)

- a. Application test.
- b. Test of a controls.
- c. Substantive test.
- d. Test of a function.

9. In obtaining an understanding of a manufacturing entity's internal control over inventory balances, an auditor **most** likely would

- a. Review the entity's descriptions of inventory policies and procedures.
- b. Perform test counts of inventory during the entity's physical count.
- c. Analyze inventory turnover statistics to identify slow-moving and obsolete items.
- d. Analyze monthly production reports to identify variances and unusual transactions.

10. Further audit procedures consist of which of the following?

	Risk assessment procedures	Substantive procedures	Test of controls
a.	Yes	No	No
b.	Yes	Yes	No
c.	No	Yes	No
d.	No	Yes	Yes

11. Which of the following statements **best** describes the ethical standard of the profession pertaining to advertising and solicitation?

- a. All forms of advertising and solicitation are prohibited.
- b. There are **no** prohibitions regarding the manner in which CPAs may solicit new business.
- c. A CPA may advertise in any manner that is **not false, misleading, or deceptive.**
- d. A CPA may only solicit new clients through mass mailings.

12. Which is **least** likely to be a question asked of client personnel during a walk-through in an audit of the internal control of an issuer (public) company?

- a. What do you do when you find an error?
- b. Who is most likely to commit fraud among your coworkers?
- c. What kind of errors have you found?
- d. Have you ever been asked to override the process or controls?

13. Which of the following matters is an auditor required to communicate to an entity's audit committee?

	Significant audit adjustments	Changes in significant accounting policies
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

14. An abnormal fluctuation in gross profit that might suggest the need for extended audit procedures for sales and inventories would **most** likely be identified in the planning phase of the audit by the use of

- a. Tests of transactions and balances.
- b. A preliminary review of internal control.
- c. Specialized audit programs.
- d. Analytical procedures.

15. When auditing merchandise inventory at year-end, the auditor performs a purchase cutoff test to obtain evidence that

- a. All goods purchased before year-end are received before the physical inventory count.
- b. No goods held on consignment for customers are included in the inventory balance.
- c. No goods observed during the physical count are pledged or sold.
- d. All goods owned at year-end are included in the inventory balance.

16. An auditor who uses the work of a specialist may refer to and identify the specialist in the auditor's report if the

- a. Specialist is also considered to be a related party.
- b. Auditor indicates a division of responsibility related to the work of the specialist.
- c. Specialist's work provides the auditor greater assurance of reliability.
- d. Auditor expresses an "except for" qualified opinion or an adverse opinion related to the work of the specialist.

17. Which of the following statements concerning audit evidence is correct?

- a. Appropriate evidence supporting management's assertions should be convincing rather than merely persuasive.
- b. Effective internal control contributes little to the reliability of the evidence created within the entity.
- c. The cost of obtaining evidence is **not** an important consideration to an auditor in deciding what evidence should be obtained.
- d. A client's accounting data **cannot** be considered sufficient audit evidence to support the financial statements.

18. Burrow & Co., CPAs, have provided annual audit and tax compliance services to Mare Corp. for several years. Mare has been unable to pay Burrow in full for services Burrow rendered nineteen months ago. Burrow is ready to begin fieldwork for the current year's audit. Under the ethical standards of the profession, which of the following arrangements will permit Burrow to begin the fieldwork on Mare's audit?

- a. Mare sets up a two-year payment plan with Burrow to settle the unpaid fee balance.
- b. Mare commits to pay the past due fee in full before the audit report is issued.
- c. Mare gives Burrow an eighteen-month note payable for the full amount of the past due fees before Burrow begins the audit.
- d. Mare engages another firm to perform the fieldwork, and Burrow is limited to reviewing the workpapers and issuing the audit report.

19. A note to the financial statements of the First Security Bank indicates that all of the records relating to the bank's business operations are stored on magnetic disks, and that there are no emergency back-up systems or duplicate disks stored since the First Security Bank and their auditors consider the occurrence of a catastrophe to be remote. Based upon this, one would expect the auditor's report to express

- a. An adverse opinion.
- b. An "except for" opinion.
- c. An unmodified (unqualified) opinion.
- d. A qualified opinion.

20. A company has changed its method of inventory valuation from an unacceptable one to one in conformity with generally accepted accounting principles. The auditor's report on the financial statements of the year of the change should include

- a. No reference to consistency.
- b. A reference to a prior period adjustment in the opinion paragraph.
- c. An emphasis-of-matter paragraph explaining the change.
- d. A justification for making the change and the impact of the change on reported net income.

21. When an auditor reissues in 20X7 the auditor's report on the 20X5 financial statements at the request of the client without revising the 20X5 wording, the auditor should

- a. Use the date of the original report.
- b. Use the date of the client's request.
- c. Use the date of the current period report.
- d. Dual date the report.

22. Which of the following is **not** a covered member for purposes of application of the independence requirements of the AICPA Code of Professional Conduct?

- a. A staff person on the attest team.
- b. A staff person that performs tax services for the attest client.
- c. The partner in charge of the firm office that performs the attest engagement.
- d. A partner that performs extensive consulting services for the attest client.

23. Accounting control procedures within computer processing may leave no visible evidence indicating that the procedures were performed. In such instances, the auditor should test these controls by

- a. Making corroborative inquiries.
- b. Observing the separation of duties of personnel.
- c. Reviewing transactions submitted for processing and comparing them to related output.
- d. Reviewing the run manual.

24. Which is **least** likely to be a response when an auditor has obtained evidence indicating a risk of material misstatement in the area of inventory?

- a. Discuss questions of inventory valuation with any other auditors involved with the audit.
- b. Make oral inquiries of major suppliers in addition to written confirmations.
- c. Perform inventory observations on an unannounced basis.
- d. Request inventory counts at the end of each month.

25. Confirmations of accounts receivable address which assertion most directly?

- a. Completeness.
- b. Existence.
- c. Valuation.
- d. Classification.

26. Which of the following is always present in an attestation engagement?

- a. Assertion about the subject matter.
- b. Generally accepted assurance principles.
- c. Subject matter.
- d. An examination report.

27. Which of the following is **not** typically performed when accountants are performing a review of the financial statements of a nonissuer?

- a. Analytical procedures applied to financial data.
- b. Inquiries about significant subsequent events.
- c. Inquiries of the client's attorney about legal matters.
- d. Obtaining an understanding of the accounting principles followed by the client's industry.

28. If information is for management's use only, which of the following forms of CPA association with financial information is **most** likely to result in no report being issued?

- a. An agreed-upon procedures engagement.
- b. An audit.
- c. A compilation.
- d. A review.

29. A CPA who is not independent may perform which of the following services for a nonissuer company?

	Compilation	Review
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

30. When performing a review of an issuer company, which is **least** likely to be included in the CPA's inquiries of management members with responsibility for financial and accounting matters?

- a. Subsequent events.
- b. Significant journal entries and other adjustments.
- c. Communications with related parties.
- d. Unusual or complex situations affecting the financial statements

Hints for Testlet 1

1. Which factor deals most directly with expected intentional misstatements?
2. The SAS provide authoritative guidance.
3. Independence is required for performing attest engagements.
4. The auditor wants to minimize the likelihood of association with a client whose management lacks integrity.
5. Remember that audits may sometimes be affected by subsequent discovery of facts existing at the date of the audit report.
6. What real world difficulty makes detecting misstatements difficult?
7. For most assertions tests of controls are not required.
8. The auditor is trying to determine the effectiveness of internal control.
9. The auditor is not evaluating the effectiveness of internal control.
10. Which set of procedures is used to design the others?
11. Advertising must be appropriate.
12. Which question seems too aggressive?
13. The audit committee that has responsibility for the oversight of the client's financial reporting process, should be kept informed about the scope and results of the audit.
14. Which substantive test relies on the premise that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary?
15. The purchase cutoff test verifies that the purchasing transactions are recorded in the proper period.
16. The auditor refers to the specialist if the auditor issues a qualified, adverse, or disclaimer as a result of the specialist's work.
17. In addition to the accounting data, the auditor must obtain corroborating audit evidence.
18. Prior year past due fees impair independence.
19. The financial statements are presented fairly in conformity with GAAP.
20. The audit report should disclose the lack of consistency.
21. Nothing has changed with regard to the 20X5 report.
22. Only managers or partners performing nonattest services for an attest client may become covered members.
23. The auditor wants to see the effects of the controls on the transactions.
24. Think of procedures that are likely to provide additional evidence relating to the financial statements being reported upon.
25. Does a confirmation assure that the account will be collected?
26. A report may ordinarily be on two of these—but one of them is always present.
27. Confirmation with outside parties is not required.
28. Which situation is most likely to result in a report that only management will use?
29. Compilations do not provide assurance.
30. Inquiries are general in nature.

Answers to Testlet 1

1. a	6. b	11. c	16. d	21. a	26. c
2. c	7. c	12. b	17. d	22. b	27. c
3. c	8. b	13. a	18. b	23. c	28. c
4. d	9. a	14. d	19. c	24. d	29. b
5. b	10. d	15. d	20. c	25. b	30. c

Explanations to Testlet 1

1. (a) Last-minute material adjustments is a situation that has been found to be associated with fraudulent financial reporting.
2. (c) The Statements on Auditing Standards are authoritative statements that are enforced through the AICPA *Code of Professional Conduct*.
3. (c) Independence is required for audits, reviews and agreed-upon procedure engagements.
4. (d) Prior to accepting the engagement, the successor auditor should obtain information to assist in deciding whether to accept the engagement, including facts that might bear on the integrity of management. All of the other items might be obtained but need not be obtained prior to acceptance.
5. (b) Under PCAOB standards, after the documentation completion date additions are allowed but deletions are not allowed.
6. (b) Employee collusion is a limitation of internal control. It may render internal control ineffective.
7. (c) Internal control must be tested when substantive procedures alone will not provide sufficient evidence.
8. (b) This describes a test of control using audit sampling.
9. (a) To obtain an understanding of internal control, the auditor would review the company's documentation of policies and procedures. Items (b), (c), and (d) are substantive tests of balances or transactions.
10. (d) After assessing risk by performing risk assessment procedures, the auditor designs further audit procedures, which include tests of controls and substantive procedures.
11. (c) The AICPA *Code of Professional Conduct* allows advertising providing it is not false, misleading or deceptive.
12. (b) "Who is most likely to commit fraud among your coworkers?" is a confrontational question that is not likely to get a meaningful response.
13. (a) The audit committee should be informed about both significant audit adjustments and changes in significant accounting policies.
14. (d) Analytical procedures involve the use of comparisons of financial and nonfinancial information to identify fluctuations that increase risk or may need investigation.
15. (d) Cutoff tests are used to determine that items are recorded in the proper accounting period.
16. (d) The auditor may refer to the specialist only when the specialist's work affects the auditor's opinion.
17. (d) A client's accounting data cannot be considered sufficient audit evidence. Responses (a), (b) and (c) are not true.
18. (b) Independence is impaired when prior year fees for professional services remain unpaid for more than one year prior to the date of the report.
19. (c) The lack of a back-up system does not affect the fairness of the financial statements. Therefore, an unmodified (unqualified) opinion would be appropriate.
20. (c) The auditors must refer to the change in an emphasis-of-matter paragraph.
21. (a) If the auditor reissues a previously issued report at the request of the client, it would normally be dated its original date. To change the date would require the auditor to perform audit procedures up to the new date.
22. (b) Covered members include members of the attest engagement team, an individual in a position to influence the attest engagement, a partner who provides nonattest services to the attest client, a partner in the office in which the lead attest engagement partner practices, and the firm. A staff person that performs tax services for the attest client is not a covered member.
23. (c) An approach to testing computer controls is comparing input to the computer output.
24. (d) Requesting inventory counts at the end of each month is least likely to be an effective procedure in this case.
25. (b) Confirmation provides evidence of the existence of recorded transactions or balance sheet amounts.
26. (c) An attestation engagement always involves comparison of a subject matter to a set of criteria.
27. (c) Inquiries of the client's attorney are not required.
28. (c) If there is no need for any assurance to a third party, the information should most likely be compiled by the CPA since the client would not generally need the assurance (or summary of findings) provided in the other reports.
29. (b) Compilations may be performed by an accountant that lacks independence but reviews may not.
30. (c) Inquiry about communications with related parties is not part of the required inquiries.

Testlet 2

1. Which of the following is **least** likely to be a test of a control?
 - a. Inquiries of appropriate personnel.
 - b. Inspection of management's engagement letter.
 - c. Observation of the application of a policy.
 - d. Repurchase of the application of a policy.
2. When one auditor succeeds another, the successor auditor should request the
 - a. Client to instruct its attorney to send a letter of audit inquiry concerning the status of the prior year's litigation, claims, and assessments.
 - b. Predecessor auditor to submit a list of internal control weaknesses that have **not** been corrected.
 - c. Client to authorize the predecessor auditor to respond to inquiries.
 - d. Predecessor auditor to update the prior year's report to the date of the change of auditors.
3. A difference of opinion concerning accounting and auditing matters relative to a particular phase of the audit arises between an assistant auditor and the auditor responsible for the engagement. After appropriate consultation, the assistant auditor asks to be disassociated from the resolution of the matter. The working papers would probably be
 - a. Silent on the matter since it is an internal matter of the auditing firm.
 - b. Expanded to note that the assistant auditor is completely disassociated from responsibility for the auditor's opinion.
 - c. Expanded to document the additional work required, since all disagreements of this type will require expanded substantive testing.
 - d. Expanded to document the assistant auditor's position, and how the difference of opinion was resolved.
4. On the audit of a nonissuer (nonpublic) company, the purpose of performing risk assessment procedures is to
 - a. Obtain an understanding of the entity and its environment.
 - b. Reduce detection risk.
 - c. Evaluate management ability.
 - d. Determine the operating effectiveness of controls.
5. Under the ethical standards of the profession, which of the following situations involving independent members of an auditor's family is most likely to impair the auditor's independence?
 - a. A parent's immaterial investment in a client.
 - b. A first cousin's loan from a client.
 - c. A spouse's employment as CEO of a client.
 - d. A sibling's loan to a director of a client.
6. Which of the following controls may prevent the failure to bill customers for some shipments?
 - a. Each shipment should be supported by a prenumbered sales invoice that is accounted for.
 - b. Each sales order should be approved by authorized personnel.
 - c. Sales journal entries should be reconciled to daily sales summaries.
 - d. Each sales invoice should be supported by a shipping document.
7. Which of the following is a control weakness for a company whose inventory of supplies consists of a large number of individual items?
 - a. Supplies of relatively little value are expensed when purchased.
 - b. The cycle basis is used for physical counts.
 - c. The storekeeper is responsible for maintenance of perpetual inventory records.
 - d. Perpetual inventory records are maintained only for items of significant value.
8. The accounts payable department receives the purchase order form to accomplish all of the following **except**:
 - a. Compare invoice price to purchase order price.
 - b. Ensure the purchase had been properly authorized.
 - c. Ensure the goods had been received by the party requesting the goods.
 - d. Compare quantity ordered to quantity purchased.
9. Before applying substantive tests to the details of asset and liability accounts at an interim date, the auditor should
 - a. Assess the difficulty in controlling incremental audit risk.
 - b. Investigate significant fluctuations that have occurred in the asset and liability accounts since the previous balance sheet date.
 - c. Select only those accounts that can effectively be sampled during year-end audit work.
 - d. Consider the tests of controls that must be applied at the balance-sheet date to extend the audit conclusions reached at the interim date.
10. Which of the following situations would **most** likely require special audit planning by the auditor?
 - a. Some items of factory and office equipment do **not** bear identification numbers.
 - b. Depreciation methods used on the client's tax return differ from those used on the books.
 - c. Assets costing less than \$500 are expensed even though the expected life exceeds one year.
 - d. Inventory is comprised of precious stones.
11. What body has the responsibility for issuing auditing standards for auditors of issuer (public) companies?
 - a. The AICPA's Auditing Standards Board.
 - b. The Chief Accountant of the Securities and Exchange Commission.
 - c. The Public Company Accounting Oversight Board.
 - d. The Financial Accounting Standards Board.

12. Morgan, CPA, is the group engagement partner (principal auditor) for the audit of a nonpublic corporation. Jones, CPA, has audited and reported on the financial statements of a significant subsidiary of the corporation. Morgan is satisfied with the independence and professional reputation of Jones, as well as the quality of Jones' audit. With respect to Morgan's report on the consolidated financial statements, taken as a whole, Morgan

- a. Must **not** refer to the audit of Jones.
- b. Must refer to the audit of Jones.
- c. May refer to the audit of Jones.
- d. May refer to the audit of Jones, in which case Morgan must include in the auditor's report on the consolidated financial statements a qualified opinion with respect to the examination of Jones.

13. If the objective of a test of details is to detect overstatements of sales, the auditor should trace transactions from the

- a. Cash receipts journal to the sales journal.
- b. Sales journal to the cash receipts journal.
- c. Source documents to the accounting records.
- d. Accounting records to the source documents.

14. The auditor's audit plan for the examination of long-term debt should include steps that require the

- a. Verification of the existence of the bondholders.
- b. Examination of any bond trust indenture.
- c. Inspection of the accounts payable subsidiary ledger.
- d. Investigation of credits to the bond interest income account.

15. All corporate capital stock transactions should ultimately be traced to the

- a. Minutes of the Board of Directors.
- b. Cash receipts journal.
- c. Cash disbursements journal.
- d. Numbered stock certificates.

16. According to the ethical standards for the profession, which of the following would impair the independence of an auditor in providing an audit for First State Bank, a nonpublic financial institution?

- a. The accountant has an automobile loan with the bank collateralized by the automobile.
- b. The accountant has a credit card with the bank with an outstanding balance of \$12,000.
- c. The accountant has a \$20,000 loan at the bank collateralized by a certificate of deposit.
- d. The accountant has a demand deposit account of \$25,000 with the bank.

17. When the audited financial statements of the prior year are presented together with those of the current year, the continuing auditor's report should cover

- a. Both years.
- b. Only the current year.
- c. Only the current year, but the prior year's report should be presented.
- d. Only the current year, but the prior year's report should be referred to.

18. Information accompanying the basic financial statements should **not** include

- a. An analysis of inventory by location.
- b. A statement that the allowance for doubtful accounts is adequate.
- c. A statement that the depreciable life of a new asset is twenty years.
- d. An analysis of revenue by product line.

19. The objective of auditing procedures applied to segment information is to provide the auditor with a reasonable basis for concluding whether

- a. The information is useful for comparing a segment of one enterprise with a similar segment of another enterprise.
- b. Sufficient evidential matter has been obtained to allow the auditor to be associated with the segment information.
- c. A separate opinion on the segment information is necessary due to inconsistent application of accounting principles.
- d. The information is presented in conformity with the FASB guidance on segment information in relation to the financial statements taken as a whole.

20. An accountant has been asked to issue a review report on the balance sheet of a nonissuer (nonpublic) company but not to report on the other basic financial statements. The accountant may **not** do so

- a. Because compliance with this request would result in an incomplete review.
- b. Because compliance with this request would result in a violation of the ethical standards of the profession.
- c. If the scope of the inquiry and analytical procedures has been restricted.
- d. If the review of the balance sheet discloses material departures from generally accepted accounting principles.

21. An auditor was unable to obtain audited financial statements or other evidence supporting an entity's investment in a foreign subsidiary. Between which of the following opinions should the entity's auditor choose?

- a. Adverse and unmodified (unqualified) with an emphasis-of-matter paragraph added.
- b. Disclaimer and unmodified (unqualified) with an emphasis-of-matter paragraph added.
- c. Qualified and adverse.
- d. Qualified and disclaimer.

22. In which of the following cases would the auditor be **most** likely to conclude that all of the items in an account under consideration should be examined rather than tested on a sample basis?

	The measure of tolerable misstatement is	Misstatement frequency is expected to be
a.	Large	Low
b.	Small	High
c.	Large	High
d.	Small	Low

23. Which of the following factors is generally **not** considered in determining the sample size for a test of controls?

- a. Risk of incorrect acceptance.
- b. Tolerable rate.
- c. Risk of assessing control risk too low.
- d. Expected population deviation rate.

24. Hart, CPA, is concerned about the type of fee arrangements that are permissible under the profession's ethical standards. Which of the following professional services may be performed for a contingent fee?

- a. A review of financial statements.
- b. An examination of prospective financial statements.
- c. Preparation of a tax return.
- d. Information technology consulting.

25. A limitation on the scope of an auditor's procedures is likely to result in a report with a(n)

	Qualified opinion	Adverse opinion
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

26. Which of the following is **least** likely to be considered when assessing inherent risk?

- a. Nonroutine transactions.
- b. Estimation transactions.
- c. Susceptibility to theft.
- d. Expected effectiveness of controls.

27. A proper report on the compilation of the financial statements that omit notes disclosure

- a. Includes an adverse opinion.
- b. Indicates that management has omitted such note disclosures.

- c. Includes a qualification or disclaimer of opinion on the accuracy of such note disclosures.
- d. Indicates that note disclosures are not necessary for those not informed about such matters.

28. Which of the following is **most** likely to result in modification of a compilation report?

- a. A departure from generally accepted accounting principles.
- b. A lack of consistency in application of generally accepted accounting principles.
- c. A question concerning an entity's ability to continue as a going concern.
- d. A major uncertainty facing the financial statements.

29. Which of the following is an accurate statement of the nature of the modification of report on a compilation of financial statements of nonissuer company when the accountant is not independent?

- a. The report need not be modified.
- b. The report must include a statement that the accountant is not independent but cannot indicate the reason for the lack of independence.
- c. The report must include a statement that the accountant is not independent and may indicate the reason for the lack of independence.
- d. A report may not be issued when the accountant is not independent.

30. Which of the following is used to obtain evidence that the client's equipment accounts are **not** understated?

- a. Analyzing repairs and maintenance expense accounts.
- b. Vouching purchases of plant and equipment.
- c. Recomputing depreciation expense.
- d. Analyzing the miscellaneous revenue account.

Hints for Testlet 2

1. Which reply relates to an auditor-prepared item?
2. The predecessor auditor has a confidential relationship with the ex-client.
3. Working papers document the audit procedures applied, the information obtained, and the conclusions reached during the engagement.
4. Audit risk often relates to business risk.
5. Which is a close relative?
6. A control should be present which readily shows a missing sales invoice.
7. Where is it most likely that control will be lost because of information overload?
8. The accounts payable department is responsible for the recordkeeping function.
9. The auditor needs to be assured that the assessed level of control risk is the same at the balance sheet date as it is at the interim date.
10. Which situation would require the auditor to use the work of a specialist?
11. What body was created by the Sarbanes-Oxley Act of 2002?
12. The group (principal) auditor must decide whether or not to assume responsibility for the work of the component (other) auditor.
13. The auditor is testing for existence.
14. The audit plan should include procedures to ensure that the debt is properly presented on the balance sheet.
15. Where does authorization for these transactions originate?
16. Which loan is unsecured?
17. The auditor's opinion regarding the financial statement should apply to the financial statements as a whole.
18. Which information is the auditor required to determine when auditing the financial statements?
19. The auditor normally considers segment information when performing an audit of financial statement in accordance with generally accepted auditing standards.
20. Limited reporting objectives is not the same as limiting the available procedures.
21. How does the auditor report a scope limitation?
22. Where does the auditor have the greatest risk of a material misstatement?
23. One reply deals with variables sampling, while three deal with attributes sampling.
24. Which services are performed only for the client?
25. A scope limitation may lead to a situation in which an auditor does not know whether the financial statements follow GAAP.
26. Remember the auditor also assesses control risk.
27. Opinions are only issued based on audits.
28. Reporting of which seems most essential to the CPA's role?
29. Report must be modified.
30. Which reply is most likely to find an equipment purchase that has not been capitalized?

Answers to Testlet 2

1. b	6. a	11. c	16. b	21. d	26. d
2. c	7. c	12. c	17. a	22. b	27. b
3. d	8. c	13. d	18. b	23. a	28. a
4. a	9. a	14. b	19. d	24. d	29. c
5. c	10. d	15. a	20. c	25. b	30. a

Explanations to Testlet 2

1. **(b)** The engagement letter has no relationship to internal control.
2. **(c)** The auditor should obtain permission from the client to communicate and get information from the predecessor auditor.
3. **(d)** In this situation, the documentation should be expanded to include the assistant's position and how the difference of opinion was resolved.
4. **(a)** Risk assessment procedures are performed to obtain an understanding of the entity and its environment to provide a basis to assess the risk of material misstatement and design further audit procedures.
5. **(c)** The spouse is a member of the CPA's immediate family and is employed in a key position.
6. **(a)** Requiring prenumbered sales invoices to support each shipment is an effective way to ensure that all shipments are billed.
7. **(c)** The individual with custody of an asset should not maintain the records.
8. **(c)** The purchase order would not have information about receipt of goods. A receiving report should also be obtained by accounts payable and would provide evidence of receipt of the goods.
9. **(a)** When a balance is audited at an interim date there is incremental audit risk that must be controlled by the auditor.
10. **(d)** The auditor normally does not have the requisite skills to determine the value of precious stones.
11. **(c)** The Public Company Accounting Oversight Board is the body responsible for issuing standards for auditors of public (issuer) companies.
12. **(c)** It is optional as to whether the group (principal) auditor refers to the other auditor in the report.
13. **(d)** To detect overstatement the auditor would normally trace transactions from the accounting records to the source documents.
14. **(b)** In auditing long-term debt the auditor should examine the bond trust indenture to assure that covenants in the indenture are adequately disclosed in the financial statements.
15. **(a)** To determine that they are authorized, capital stock transactions should be traced to authorization in the minutes of board of director or shareholder meetings.
16. **(b)** An interpretation of the independence rule prohibits credit card accounts in excess of \$10,000.
17. **(a)** A continuing auditor's report should cover both years.
18. **(b)** If the allowance for doubtful accounts is inadequate, this fact should result in a qualification of the auditor's opinion.
19. **(d)** The procedures are performed to determine that the information is presented in conformity with the FASB requirements in relation to the financial statements taken as a whole.
20. **(c)** An accountant may review a balance sheet providing the scope of the procedures is not limited.
21. **(d)** If the auditor cannot obtain sufficient evidence, he or she must choose between a qualified opinion and a disclaimer, depending on the significance of the limitation.
22. **(b)** The auditor would most likely decide not to sample when the tolerable misstatement is small and the expected misstatement rate is high. In this case it would be more appropriate to examine all or most of the items in the population.
23. **(a)** The risk of incorrect acceptance is a consideration when sampling is used for a substantive procedure.
24. **(d)** The *Code of Professional Conduct* prohibits contingent fees for audits or reviews of financial statements, examinations of prospective financial information, and preparation of tax returns.
25. **(b)** A significant limitation in the scope of audit procedures would result in a qualified opinion or a disclaimer of opinion depending on its significance.
26. **(d)** The effectiveness of internal control is a consideration regarding control risk.
27. **(b)** The professional standards require that the CPA clearly indicate in the accountants' report the omission.
28. **(a)** Compilation reports are modified for departures from generally accepted accounting principles. The other items do not affect compilation reports.
29. **(c)** The accountant must modify the report and may indicate the reason for lack of independence.
30. **(a)** Analyzing repairs and maintenance expense may result in the discovery of property and plant expenditures that were erroneously expensed.

Testlet 3

1. The risk that an auditor's procedures will lead to the conclusion that a material misstatement does **not** exist in an account balance when, in fact, such misstatement does exist is referred to as
 - a. Audit risk.
 - b. Inherent risk.
 - c. Control risk.
 - d. Detection risk.
2. Which of the following is an audit **least** likely to detect?
 - a. Theft of cash received from collection of accounts receivable.
 - b. Intentional omission of transactions relating to equipment purchases.
 - c. Intentional violations of occupational safety and health laws.
 - d. Misapplication of accounting principles relating to inventory.
3. Prior to beginning the fieldwork on a new audit engagement in which a CPA does **not** possess expertise in the industry in which the client operates, the CPA should
 - a. Reduce audit risk by lowering the preliminary levels of materiality.
 - b. Design special substantive tests to compensate for the lack of industry expertise.
 - c. Engage financial experts familiar with the nature of the industry.
 - d. Obtain a knowledge of matters that relate to the nature of the entity's business.
4. For purposes of an audit of internal control performed under Public Company Accounting Oversight Board standards, a significant deficiency is a control deficiency that
 - a. Is at least as severe as a material weakness.
 - b. Is probable of occurring in an amount that is material.
 - c. Must be communicated to those responsible for oversight of the company's financial reporting.
 - d. Remains unresolved at the date of completion of final internal control analysis procedures.
5. Under the ethical standards of the profession, which of the following investments in a client is **not** considered to be a direct financial interest?
 - a. An investment held through a nonclient regulated mutual fund.
 - b. An investment held through a nonclient investment club.
 - c. An investment held in a blind trust.
 - d. An investment held by the trustee of a trust.
6. Audit evidence on the proper segregation of duties ordinarily is **best** obtained by
 - a. Preparation of a flowchart of duties performed by available personnel.
 - b. Inquiring whether control activities operated consistently throughout the period.
 - c. Reviewing job descriptions prepared by the personnel department.
 - d. Direct personal observation of the employees who apply control activities.
7. In considering internal control, the auditor is basically concerned that it provides reasonable assurance that
 - a. Operational efficiency has been achieved in accordance with management plans.
 - b. Material misstatements due to errors and fraud have been prevented or detected.
 - c. Controls have **not** been circumvented by collusion.
 - d. Management **cannot** override the system.
8. In properly designed internal control, the same employee should **not** be permitted to
 - a. Sign checks and cancel supporting documents.
 - b. Receive merchandise and prepare a receiving report.
 - c. Prepare disbursement vouchers and sign checks.
 - d. Initiate a request to order merchandise and approve merchandise received.
9. Which of the following is an effective control over cash payments?
 - a. Signed checks should be mailed under the supervision of the check signer.
 - b. Spoiled checks that have been voided should be disposed of immediately.
 - c. Checks should be prepared only by persons responsible for cash receipts and cash disbursements.
 - d. A check-signing machine with two signatures should be utilized.
10. Inquiries of warehouse personnel concerning possible obsolete or slow-moving inventory items provide assurance about management's assertion of
 - a. Completeness.
 - b. Existence.
 - c. Presentation.
 - d. Valuation.
11. The **primary** reason an auditor requests letters of inquiry be sent to a client's attorneys is to provide the auditor with
 - a. A description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet.
 - b. An expert opinion as to whether a loss is possible, probable, or remote.
 - c. The opportunity to examine the documentation concerning litigation, claims, and assessments.
 - d. Corroboration of the information furnished by management concerning litigation, claims, and assessments.

12. Lott and Lott, CPAs, recently acquired a public company as an audit client. With respect to this client, the Sarbanes-Oxley Act of 2002 requires

- a. Rotation of accounting firms every five years.
- b. Joint audits by two auditing firms.
- c. Rotation of the partner in charge of the audit every five years.
- d. Joint management of the audit by two or more partners.

13. When providing limited assurance that the financial statements of a nonissuer (nonpublic) entity require **no** material modifications to be in accordance with generally accepted accounting principles, the accountant should

- a. Understand internal control.
- b. Test the accounting records that identify inconsistencies with the prior year's financial statements.
- c. Understand the accounting principles of the industry in which the entity operates.
- d. Develop audit programs to determine whether the entity's financial statements are fairly presented.

14. According to the ethical standards for the profession, which of the following fee arrangements is prohibited?

- a. A fee for a review of financial statements that is based on time spent on the engagement.
- b. A fee for a review of financial statements that is based on time spent and a premium for the risk involved.
- c. A fee for a review engagement that is based on a fixed fee of \$5,000.
- d. A fee for a review engagement that varies depending on the amount of financing that the company may obtain.

15. Which of the following procedures is **not** included in a review engagement of a nonissuer (nonpublic) entity?

- a. Inquiries of management.
- b. Inquiries regarding events subsequent to the balance sheet date.
- c. Any procedures designed to identify relationships among data that appear to be unusual.
- d. Tests of internal control.

16. Which of the following is **not** considered by the PCAOB as an indicator of the existence of a material weakness in internal control?

- a. Identification of a material fraud committed by senior management in the areas of sales.
- b. Restatement of previously issued financial statements to reflect correction of a material misstatement relating to improper inventory valuation.
- c. Identification by the auditor of a material misstatement in cost of goods sold in circumstances that indicate that the misstatement would not have been detected by the company's internal control.
- d. Lack of oversight by the audit committee of details of raw material purchases.

17. Kane, CPA, concludes that there is substantial doubt about Lima Co.'s ability to continue as a going concern for a reasonable period of time. If Lima's financial statements adequately disclose its financial difficulties, Kane's auditor's

report is required to include a paragraph that specifically uses the phrase(s)

	"Possible discontinuance of operations"	"Reasonable period of time, not to exceed 1 year"
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

18. How are management's responsibility and the auditor's responsibility represented in the standard auditor's report?

	Management's responsibility	Auditor's responsibility
a.	Explicitly	Explicitly
b.	Implicitly	Implicitly
c.	Implicitly	Explicitly
d.	Explicitly	Implicitly

19. In estimation sampling for attributes, which one of the following must be known in order to appraise the results of the auditor's sample?

- a. Estimated dollar value of the population.
- b. Standard deviation of the values in the population.
- c. Actual occurrence rate of the attribute in the population.
- d. Sample size.

20. Processing data through the use of simulated files provides an auditor with information about the reliability of controls. One of the techniques involved in this approach makes use of

- a. Controlled reprocessing.
- b. Integrated test facility.
- c. Input validation.
- d. Program code checking

21. After the audit documentation completion date, the auditor

- a. May not delete any audit documentation.
- b. May not make changes in audit documentation.
- c. May not add new information to audit documentation.
- d. May make changes or deletions to audit documentation providing that the fact that alterations were made is documented.

22. Prior to or in conjunction with obtaining information to identify risks of fraud, which of the following is required?

- a. A brainstorming session among team members about where financial statements may be susceptible to fraud.
- b. A discussion with the client's legal counsel as to contingent liabilities likely to affect the financial statements.
- c. Indirect verification of significant financial statement assertions.
- d. Professional skepticism concerning illegal acts that do not have an effect on financial statement amounts.

23. Which of the following is **not** ordinarily performed in response to the risk of management override?

- a. Evaluating the rationale for significant unusual transactions.
- b. Observe counts of inventory at all locations.

- c. Review accounting estimates for bias.
- d. Test appropriateness of journal entries and adjustments.

24. When an auditor has a question concerning a client's ability to continue as a going concern, the auditor considers management's plans for dealing with the situation. That consideration is **most** likely to include consideration of management's plans to

- a. Decrease ownership equity.
- b. Dispose of assets.**
- c. Increase expenditures on key products.
- d. Invest in derivative securities.

25. A change from one accounting principle to another with which the auditor concurs is likely to result in a report with a(n)

	Qualified opinion	Adverse opinion
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

26. A significant circumstance-caused scope limitation in a Sarbanes/Oxley 404 internal control audit is more likely to result in a(n)

- a. Adverse opinion.
- b. Qualified opinion.
- c. Unmodified (unqualified) opinion with an emphasis-of-matter paragraph.
- d. Scope reduction opinion.

27. According to the ethical standards for the profession, which of the following is **not** acceptable advertising content?

- a. The fees for services.
- b. The qualifications of professional staff.

- c. Implications regarding the ability to influence regulatory bodies.**

- d. Implications regarding the value of the services.

28. An accountant should establish an understanding with management regarding the services to be performed and document in writing for a

	Compilation	Review
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

29. Wilson, CPA, has been engaged to review the financial statements of Roland Company, a nonissuer company. The management of Roland Company has refused to sign a representation letter for the engagement. What should be Wilson's response?

- a. Not issue a review report.**
- b. Issue a standard review report providing all other review procedures were performed.
- c. Issue a review report modified for a scope restriction.
- d. Issue a review report modified for a possible departure from generally accepted accounting principles.

30. Violation of which of the following is **most** likely to be considered a "direct effect" illegal act?

- a. Environmental protection laws.
- b. Occupational safety and health law violations.
- c. Securities trading laws.
- d. Tax laws.**

Hints for Testlet 3

1. The auditor performs audit procedures to detect material misstatements in the account balance.
2. Which is least likely to misstate financial statement amounts?
3. The CPA must understand the business issues of the company and industry.
4. Think about control deficiencies, significant deficiencies, and material weaknesses.
5. What is an indirect financial interest?
6. Which control gives the auditor the best idea about the daily operation of the company?
7. Which area does the auditor have the most control over?
8. Segregate recordkeeping from authorization.
9. Which control helps the client maintain accountability for the cash payments?
10. Obsolete or slow-moving inventory may never be sold and so the amount of inventory presented on the balance sheet may be overstated.
11. The client has primary responsibility for the fair presentation of the financial statements.
12. Partner rotation helps assure independence.
13. A requirement for any engagement is for the auditor to understand the environment they are working in.
14. Which fee is contingent?
15. A review engagement provides only limited assurance.
16. Think carefully about the indicators provided by the PCAOB.
17. Mentally “write” an emphasis-of-matter paragraph and consider whether it is likely that these items would be required.
18. The standard audit report should give the reader a clear understanding about responsibilities.
19. The auditor wants to determine a deviation rate for the sample.
20. Which technique places the simulated files into the midst of live transactions?
21. Documentation should be as accurate as possible.
22. One of these is intended to get the audit team “up to speed” in the area.
23. Which procedure may not be practical in some situations?
24. Consider a reply that will provide resources to the company.
25. Clients are able to change accounting principles.
26. Scope limitations may result in two types of opinion—only one is listed.
27. Which is false, misleading, or deceptive?
28. For both types of association a CPA attempts to avoid misunderstandings.
29. Scope limitation reports are not allowed.
30. Which is most likely to result in direct misstatement of a financial statement account balance?

Answers to Testlet 3

1. d	6. d	11. d	16. d	21. d	26. b
2. c	7. b	12. c	17. d	22. a	27. c
3. d	8. c	13. c	18. a	23. b	28. a
4. c	9. a	14. d	19. d	24. b	29. a
5. a	10. d	15. d	20. b	25. d	30. d

Explanations to Testlet 3

1. (d) Detection risk is the risk that the auditor's procedures will fail to detect a material misstatement if it exists.
2. (c) Intentional violations of occupational safety and health laws are the most difficult to detect because they are not related to financial statement numbers and they are not within the auditor's expertise.
3. (d) If the auditor does not have an understanding of the client's industry, he or she should obtain that understanding.
4. (c) A significant deficiency is a matter that must be communicated to those responsible for oversight of the company's financial reporting process because it should be of interest to those individuals.
5. (a) An investment in a mutual fund that holds an investment in a client is considered to be an indirect financial interest.
6. (d) Direct personal observations of employees performing activities is the best test of segregation of duties.
7. (b) Internal control should be designed to provide reasonable assurance that material errors or fraud are prevented, or detected and corrected.
8. (c) In a properly designed system of internal control an individual should not have custody of assets (be able to sign checks) and also keep accounting records (prepare disbursement vouchers).
9. (a) For appropriate internal control the check signer should supervise the mailing of the checks.
10. (d) Inquiries of warehouse personnel about obsolete or slow-moving inventory items is designed to identify items that may be overvalued.
11. (d) The attorney's letter corroborates the information about litigation, claims, and assessments provided by management.
12. (c) The Sarbanes-Oxley Act requires rotation of the partner in charge of the audit every five years.
13. (c) Statements on Standards for Accounting and Review Services requires the accountant to understand the accounting principles of the industry in which the entity operates. All the other items are not required.
14. (d) A fee that varies depending on the amount of financing obtained is a contingent fee that is not allowed for a review engagement.
15. (d) A review of the financial statements of a nonissuer company does not involve tests of the effectiveness of internal control.
16. (d) The audit committee would not be expected to oversee the details of raw material purchases.
17. (d) Neither of these phrases is required in the auditor's emphasis-of-matter paragraph.
18. (a) The auditor's report explicitly describes management's responsibility and the auditor's responsibility.
19. (d) The sample size and the occurrence rate in the sample are the items that must be known to evaluate the sample results.
20. (b) An integrated test facility introduces test (dummy) transactions with live transactions to test the effectiveness of IT controls.
21. (d) The auditor may make changes or deletions to audit documentation providing the fact that the changes were made is documented.
22. (a) Auditing standards require a brainstorming session among audit team members regarding where the financial statements may be susceptible to fraud.
23. (b) Observation of inventory is not ordinarily a procedure performed in response to the risk of management override of internal control.
24. (b) Management plans to deal with a going-concern issue usually involves disposition of assets or obtaining additional financing.
25. (d) A change from one acceptable accounting principle to another acceptable principle does not result in either a qualified opinion or an adverse opinion. An unmodified (unqualified) opinion with emphasis-of-matter language is appropriate.
26. (b) A circumstance-caused scope limitation would normally result in a qualified opinion.
27. (c) Advertising content that implies the ability to influence regulatory bodies would be considered false, misleading, or deceptive.
28. (a) Both types of engagements require such a written communication.
29. (a) If the scope is restricted by management, the accountant should not issue a report.
30. (d) Direct-effect illegal acts affect the numbers in the financial statements. An important example is the violation of a tax law.

Appendix C: Sample Auditing and Attestation Testlet Released by AICPA

1. According to the profession's ethical standards, an auditor would be considered independent in which of the following instances?

- a. The auditor is the officially appointed stock transfer agent of a client.
- b. The auditor's checking account that is fully insured by a federal agency is held at a client financial institution.
- c. The client owes the auditor fees for more than two years prior to the issuance of the audit report.
- d. The client is the only tenant in a commercial building owned by the auditor.

2. Which of the following characteristics **most** likely would heighten an auditor's concern about the risk of material misstatements in an entity's financial statements?

- a. The entity's industry is experiencing declining customer demand.
- b. Employees who handle cash receipts are **not** bonded.
- c. Bank reconciliations usually include in-transit deposits.
- d. Equipment is often sold at a loss before being fully depreciated.

3. Which of the following fraudulent activities **most** likely could be perpetrated due to the lack of effective internal controls in the revenue cycle?

- a. Fictitious transactions may be recorded that cause an understatement of revenues and an overstatement of receivables.
- b. Claims received from customers for goods returned may be intentionally recorded in other customers' accounts.
- c. Authorization of credit memos by personnel who receive cash may permit the misappropriation of cash.
- d. The failure to prepare shipping documents may cause an overstatement of inventory balances.

1. (b) The requirement is to identify the instance in which an auditor would be considered independent. Answer (b) is correct because the auditor's independence would not be impaired, provided the checking accounts, etc. are fully insured by an appropriate deposit insurance agency. Answer (a) is incorrect because an auditor's independence would be impaired since the function of a transfer agent is considered equivalent to that of a member of management. Answer (c) is incorrect because an auditor's independence is considered to be impaired if, when the report on the client's current year is issued, fees remain unpaid, whether billed or unbilled, for professional services provided more than one year prior to the date of the report. Answer (d) is incorrect because leasing property to a client results in an indirect financial interest in that client. Therefore, an auditor's independence would be considered to be impaired if the indirect financial interest in a client is material to the auditor.

2. (a) The requirement is to identify the characteristic that would **most** likely heighten an auditor's concern about the risk of material misstatements in an entity's financial statements. Answer (a) is correct because the professional standards indicate that a declining industry with increasing business failures and significant declines in customer demand is a risk factor relating to misstatements arising from fraudulent financial reporting. Answer (b) is incorrect because bonding will not necessarily affect the risk of material misstatements. Answer (c) is incorrect because many bank reconciliations ordinarily include in-transit deposits and this does not necessarily increase the risk of material misstatement. Answer (d) is incorrect because equipment sold at a loss may often occur (as may gains) and not necessarily affect the risk of material misstatement.

3. (c) The requirement is to identify the fraudulent activity **most** likely to be perpetrated due to the lack of effective internal control over the revenue cycle. Answer (c) is correct because the authorization of credit memos by personnel who receive cash presents a situation in which those individuals may issue fraudulent credit memos and misappropriate the cash. Answer (a) is incorrect because one would expect such fictitious transactions to overstate both revenues and receivables; note that the situation described in answer (a) with an understatement of revenues and an overstatement of receivables results in two debits and no credits. Answer (b) is incorrect because recording such claims in the wrong account is likely to be quickly detected when customers who have not received the credit complain. Answer (d) is incorrect because such an overstatement of inventory balances is likely to be detected through an inventory observation.

4. In planning an audit, the auditor's knowledge about the design of relevant controls should be used to

- a. Identify the types of potential misstatements that could occur.
- b. Assess the operational efficiency of internal control.
- c. Determine whether controls have been circumvented by collusion.
- d. Document the assessed level of control risk.

5. Which of the following information discovered during an audit most likely would raise a question concerning possible illegal acts?

- a. Related-party transactions, although properly disclosed, were pervasive during the year.
- b. The entity prepared several large checks payable to cash during the year.
- c. Material internal control weaknesses previously reported to management were **not** corrected.
- d. The entity was a campaign contributor to several local political candidates during the year.

6. During an engagement to review the financial statements of a nonissuer (nonpublic) entity, an accountant becomes aware that several leases that should be capitalized are not capitalized. The accountant considers these leases to be material to the financial statements. The accountant decides to modify the standard review report because management will not capitalize the leases. Under these circumstances, the accountant should

- a. Issue an adverse opinion because of the departure from GAAP.
- b. Express **no** assurance of any kind on the entity's financial statements.
- c. Emphasize that the financial statements are for limited use only.
- d. Disclose the departure from GAAP in a separate paragraph of the accountant's report.

4. (a) The requirement is to determine how the auditor's knowledge about the design of relevant controls is used in planning an audit. Answer (a) is correct because such knowledge is used to (1) identify types of potential misstatements, (2) consider factors that affect the risk of material misstatements, and (3) design substantive tests. Answer (b) is incorrect because auditors are more concerned with identifying types of potential misstatements not detected by internal control rather than with assessing its operational efficiency. Answer (c) is incorrect because while auditors are concerned with whether controls are circumvented by collusion, this is not the primary emphasis during planning and is less complete than answer (a). Answer (d) is incorrect because documentation during planning emphasizes the auditor's understanding of the entity's internal control.

5. (b) The requirement is to identify the information that most likely would raise a question concerning possible illegal acts. Answer (b) is correct because such large checks payable to cash raise a question as to their actual business purpose. Answer (a) is incorrect because the mere existence of **properly disclosed** related-party transactions is less likely to indicate an illegal act than are checks written to cash. Answer (c) is incorrect because management may, for valid reasons, choose to not correct material internal control weaknesses. Answer (d) is incorrect because such campaign contributions may well be legal.

6. (d) The requirement is to determine an accountant's reporting responsibility when associated with a nonissuer (nonpublic) entity's **reviewed** statements which contain a material departure from generally accepted accounting principles. Answer (d) is correct because AR 100 requires the inclusion of a separate paragraph describing the departure. Answer (a) is incorrect because an adverse opinion may only be issued when an audit has been performed. Answer (b) is incorrect because a review report provides negative assurance, not **no** assurance. Answer (c) is incorrect because a review report is ordinarily available for general distribution, and need not emphasize that the financial statements are for limited use only.

Appendix D: 2015 Released AICPA Questions for Auditing and Attestation

1. Which of the following statements correctly defines the term *reasonable assurance*?

- a. A substantial level of assurance to allow an auditor to detect a material misstatement.
- b. A significant level of assurance to allow an auditor to detect a material misstatement.
- c. An absolute level of assurance to allow an auditor to detect a material misstatement.
- d. A high, but **not** absolute, level of assurance to allow an auditor to detect a material misstatement.

2. A practitioner may perform an agreed-upon procedures engagement on prospective financial statements provided that which of the following is met?

- a. Use of the agreed-upon procedures report is **not** restricted.
- b. The practitioner sets the criteria to be used in the determination of findings.
- c. The client agrees that the practitioner will decide appropriate procedures to be performed.
- d. The prospective financial statements include a summary of significant assumptions.

3. If the predecessor auditor refuses to give the current auditor of a nonissuer access to the documentation, what should the current auditor do?

- a. Review the risk assessment of the opening balances of the financial statements.
- b. Withdraw from the engagement.
- c. Disclaim an opinion due to a scope limitation.
- d. Discuss the matter with the client's legal counsel.

4. Analytical procedures used in planning an audit should focus on:

- a. Identifying material weaknesses in internal control.
- b. Enhancing the auditor's understanding of the client's business.
- c. Testing individual account balances that depend on accounting estimates.
- d. Evaluating the adequacy of the evidence gathered concerning unusual balances.

1. Answer (d) is correct because the professional standards state that reasonable assurance is a high, but not absolute, level of assurance; auditors obtain reasonable assurance when performing audits. Answer (a) is incorrect because the term "substantial level of assurance" is not used in the auditing standards. Answer (b) is incorrect because the term "significant level of assurance" is not used in the auditing standards. Answer (c) is incorrect because reasonable assurance is short of absolute assurance—auditors do not provide absolute assurance.

2. Answer (d) is correct because the attestation standards require that prospective financial statements include a summary of significant assumptions. Answer (a) is incorrect because agreed-upon procedures reports are restricted. Answer (b) is incorrect because the specified parties (those who request the service) set the criteria. Answer (c) is incorrect because the specified parties (those who request the service) decide upon which procedures they want performed.

3. Answer (a) is correct because a predecessor auditor's refusal to allow access to the documentation may affect the auditor's assessment of risk regarding the opening balances and in a situation such as this may be expected to result in the auditor performing additional procedures. Answer (b) is incorrect because, in most situations, one would expect the successor to be able to obtain sufficient appropriate audit evidence through application of relating procedures relating to the opening balances. Answer (c) is incorrect because other procedures are ordinarily available relating to the opening balances, information ordinarily obtained from the predecessor. Answer (d) is incorrect because discussion with legal counsel generally is not necessary in this circumstance.

4. Answer (b) is correct because during the risk assessment process auditors use analytical procedures to enhance their knowledge of the client's business and, as a part of this process, they use this information to plan appropriate procedures to address the risks of material misstatement. Answer (a) is incorrect because while a material weakness may be identified, this is not the focus of analytical procedures used in planning. Answer (c) is incorrect because analytical procedures in used in planning provide no particular advantage relating to accounts that depend on accounting estimates during planning. Answer (d) is incorrect because analytical procedures performed at the risk assessment stage (planning) occur prior to collection of most of the necessary evidence on the various accounts, those with and those without unusual balances.

5. If an auditor is obtaining an understanding of an issuer's information and communication component of internal control, which of the following factors should the auditor assess?

- a. The integrity and ethical values of top management.
- b. The philosophy and operating style of management to promote effective internal control over financial reporting.
- c. The classes of transactions in the issuer's operations that are significant to the issuer's financial statements.
- d. The oversight responsibility over financial reporting and internal control by the board or audit committee.

6. Which of the following is **not** a role of the risk assessment in an integrated audit of a nonissuer?

- a. Concluding on the effectiveness of a given control.
- b. Selecting controls to test.
- c. Determining significant accounts and relevant assertions.
- d. Determining evidence necessary to conclude on the effectiveness of a given control.

7. Which of the following situations represents a limitation, rather than a failure, of internal control?

- a. A jewelry store employee steals a small necklace from a display cabinet.
- b. A bank teller embezzles several hundred dollars from the cash drawer.
- c. A purchasing employee and an outside vendor participate in a kickback scheme.
- d. A movie theater cashier sells reduced-price tickets to full-paying customers and pockets the difference.

8. An audit client has substantial assets held in a trust that is managed by the trust department of a bank. Which of the following actions by the auditor is the most efficient way to obtain information about the trust department's internal controls?

- a. Perform a review or compilation of the trust department.
- b. Perform tests of controls on a sample of the client's transactions with the trust department.
- c. Rely on the trust department's audit report on internal controls placed in operation and their operating effectiveness.
- d. Ask management of the trust department to complete a questionnaire about internal controls and provide flowcharts for related processes.

5. Answer (c) is correct because an auditor's understanding of an issuer's information and communication component of internal control relates most directly to the significant classes of transactions. Answer (a) is incorrect because the control environment includes integrity and ethical values. Answer (b) is incorrect because management's philosophy and operating style is considered in the control environment. Answer (d) is incorrect oversight relates most directly to the monitoring component of internal control.

6. Answer (a) is correct, not a role in the risk assessment, because the objective is to express overall opinions on internal control and the financial statements, not to express an opinion on the effectiveness of each individual control; also, in the early risk assessment information on such effectiveness has not yet been collected. Answer (b) is incorrect because selecting controls to test is a part of the role. Answer (c) is incorrect because determining significant account and assertions is a part of the role. Answer (d) is incorrect because determining evidence necessary to conclude on the effectiveness of a given control is a part of the role.

7. Answer (c) is correct because the professional standards indicate that collusion among individuals is a limitation of internal control in that it may allow those individuals to circumvent controls; here a control over disbursements may exist but be circumvented through two (or more) individuals working together to "beat" (make ineffective) the control. Answer (a) is incorrect because there apparently is no operating control over the display cabinet. Answer (b) is incorrect because there apparently is no operating control over cash in the cash drawer. Answer (d) is incorrect because there apparently is no operating control over who is sold reduced-price tickets.

8. Answer (c) is correct because auditors often rely upon service organization reports that provide assurance with respect to those controls; these reports are used by auditors ("user auditors") and companies that use the services of the service organization. Answer (a) is incorrect because review and compilation reports do not provide assurance on internal control. Answer (b) is incorrect because while performing such tests of controls is possible, it is unlikely to be the most efficient approach. Answer (d) is incorrect because no such questionnaire is used.

9. Which of the following levels would most likely address the risk of material misstatement by the auditor's consideration of an entity's control environment?

- a. Financial statements.
- b. Disclosures.
- c. Classes of transactions.
- d. Specific account balances.

10. In addition to descriptions of the nature, timing, and extent of planned risk assessment procedures and planned further audit procedures, which of the following additional pieces of information should be documented in the audit plan?

- a. Procedures performed to assess independence and the ability to perform the engagement.
- b. The understanding of the terms of the engagement, including scope, fees, and resource allocation.
- c. Other audit procedures to be performed to comply with generally accepted auditing standards.
- d. Issues with management integrity that could affect the decision to continue the audit engagement.

11. An audit team has concluded that inventory is highly susceptible to misappropriation and that a potential misstatement would be material to the financial statements. How should the audit team address the audit procedures to the increased risk?

- a. Review the client's control procedures over the safeguarding of inventory, and perform a physical inventory count on the last day of the current year.
- b. Review the client's control procedures over the safeguarding of inventory, incorporate the use of substantive analytical procedures, and develop an expectation.
- c. Review the client's control procedures over the safeguarding of inventory, but do **not** modify substantive procedures over inventory.
- d. Review the client's control procedures over the safeguarding of inventory, and perform physical inventory counts throughout the current year.

12. When planning an engagement to examine the effectiveness of the entity's internal control in an integrated audit of a nonissuer, a practitioner would **least** likely consider which of the following factors?

- a. Preliminary judgments about the effectiveness of internal control.
- b. The extent of recent changes in the entity and its operations.
- c. The type of available evidential matter pertaining to the effectiveness of the entity's internal control.
- d. The evaluation of the operating effectiveness of the controls.

9. Answer (a) is correct because the professional standards suggest that risks of material misstatement at the financial statement level may derive, in particular, from a deficient control environment. Answer (b) is incorrect because the control environment is not as directly related to disclosures as it does to the proper reply. Answer (c) is incorrect because the control environment does not relate as directly to classes of transactions as it does to the proper reply. Answer (d) is incorrect because the control environment does not relate as directly to specific account balances as it does to the proper reply.

10. Answer (c) is correct because the audit plan (program) should include the various types of audit procedures performed during the audit. Answer (a) is incorrect because procedures performed to assess independence are ordinarily more directly related to the firm's quality controls. Answer (b) is incorrect because this understanding is documented in the engagement letter. Answer (d) is incorrect because these issues, if they arise, will be included in the audit documentation itself.

11. Answer (a) is correct because in such a high risk environment the timing of procedures may be performed at year-end (the balance being reported upon in the audit report), rather than at interim periods. Answer (b) is incorrect because substantive analytical procedures may not be as reliable as an inventory count at identifying misappropriation. Answer (c) is incorrect because the increased risk would suggest the need to modify substantive procedures when the auditor had not been aware of the risk when originally planning the audit. Answer (d) is incorrect because a year-end count is more likely to be performed since the company is reporting as of the last day of the year.

12. Answer (d) is correct because evaluation of the operating effectiveness of controls occurs after tests of controls have been performed, which is after planning. Answer (a) is incorrect because a practitioner should make preliminary judgments about the effectiveness of internal control during planning. Answer (b) is incorrect because during planning a practitioner should consider recent changes in the entity and its operations since those changes may require changes in the scope of the engagement. Answer (c) is incorrect because during planning a practitioner should consider the type of evidence available so as to be able to design procedures.

13. In the audit of a nonissuer, which of the following statements is correct regarding the use of external confirmations to obtain audit evidence?

- a. Management's refusal to allow an auditor to perform external confirmation procedures is considered a departure from GAAP sufficient to qualify the opinion.
- b. Negative confirmations provide more persuasive audit evidence than positive confirmations.
- c. Negative confirmations should be used only if a very high exception rate is expected.
- d. A factor for an auditor to consider when designing confirmation requests is the assertion being tested.

14. After performing a compliance audit of an entity that received federal funds, what conclusion would the auditor draw if the entity does **not** have adequate documentation to support \$5 million in operating expenses paid from federal program funds?

- a. The entity spent \$5 million in operating expenses that were **not** approved.
- b. Questioned costs of \$5 million for operating expenses have been identified.
- c. The entity spent \$5 million of government funds for services that were **not** required.
- d. The entity submitted unauthorized invoices for expenses.

15. An auditor of a nonissuer is most likely to conclude that a misstatement identified during an audit that is below the quantitative materiality limit is qualitatively material if it

- a. Changes the company's operating results from a net loss to a net income.
- b. Arises from a transaction cycle with controls that were determined to be operating effectively.
- c. Is the first time a misstatement has arisen from the relevant transaction cycle.
- d. Decreases management's incentive compensation for the period.

16. What is the maximum number of days in which a nonissuer's auditor should complete the assembly of the final audit file following the report release date?

- a. 30 days.
- b. 45 days.
- c. 60 days.
- d. 75 days.

17. In an integrated audit of a nonissuer, if an auditor concludes that a material weakness exists as of the date specified in management's assertion, the auditor should take which of the following actions?

- a. Obtain written representations from management relating to such matters.
- b. Communicate, in writing, to the entity's outside legal counsel that the material weakness exists.
- c. Issue an adverse opinion.
- d. Disclaim an opinion.

13. Answer (d) is correct because confirmations are often better for some assertions (e.g., existence) than they are for others (completeness). Answer (a) is incorrect because management refusal is a scope limitation, not a departure from GAAP. Answer (b) is incorrect because positive, not negative, confirmations ordinarily provide more persuasive audit evidence. Answer (c) is incorrect because negative confirmations are ordinarily used when there is a low exception rate.

14. Answer (b) is correct because such costs that are inadequately supported are referred to as questioned costs. Answer (a) is incorrect because the operating expenses may or may not have been properly approved. Answer (c) is incorrect because the services may or may not have been required. Answer (d) is incorrect because there is no indication of submission of unauthorized invoices.

15. Answer (a) is correct because a misstatement that changes a company's operating results from a net loss to a net income may be considered important by a financial statement user who is particularly concerned when a loss of any magnitude occurs. Answer (b) is incorrect because the misstatement itself, not that it arose in a cycle the auditor believed to operate effectively, is of most significance. Answer (c) is incorrect because whether it is the first or second time may not necessarily affect the materiality decision. Answer (d) is incorrect because the professional standards state that such a misstatement that has the effect of *increasing* not decreasing management's compensation may be material.

16. Answer (c) is correct because the documentation completion period, the number of days a nonissuer's auditor may use to complete assembly of the final audit file, is 60 days for a nonissuer's auditor. Answer (a) is incorrect because the documentation completion period is longer than 30 days. Answer (b) is incorrect because while 45 days is the documentation completion period for issuers, it is not for nonissuers. Answer (d) is incorrect because the documentation completion period is less than 75 days.

17. Answer (c) is correct because the existence of a material weakness results in an adverse opinion. Answer (a) is incorrect because no such written representation need be obtained. Answer (b) is incorrect because, ordinarily, outside counsel need not be contacted. Answer (d) is incorrect because a disclaimer of opinion is not issued in this situation.

18. A nonissuer requests that a CPA change an audit engagement to a review engagement. If the accountant agrees to the change, how, if at all, should the accountant's review report be modified?

- a. The accountant should issue the review report without mentioning the change in engagement.
- b. The accountant should include in the review report a disclaimer of an audit opinion.
- c. The accountant should include in the review report the circumstances that resulted in the change in engagement.
- d. The accountant should include in the review report a reference to the original engagement but **not** the reason for the change.

19. Which of the following procedures regarding notes payable would an accountant most likely perform during a nonissuer's review engagement?

- a. Confirming the year-end outstanding note payable balance with the lender.
- b. Examining records indicating proper authorization of the notes payable.
- c. Making inquiries of management regarding maturities, interest rate, and collateral.
- d. Documenting control procedures for payment calculations of the notes' principal and interest.

20. When financial statements that an accountant has compiled in accordance with *Statements on Standards for Accounting and Review Services* omit substantially all disclosures required by generally accepted accounting principles, the accountant's report should include

- a. Management's justification for its decision to elect to omit substantially all the disclosures.
- b. No modification of the standard compilation report because compilations do **not** require disclosures that are required for audited financial statements.
- c. Information alerting readers about omission of the disclosures and notification that the omission may influence the user's conclusions about the financial statements.
- d. A separate paragraph in the compilation report stating that the financial statements are misleading due to the lack of disclosures by management.

21. The standard accountant's report issued after reviewing the financial statements of a nonissuer in accordance with SSARS should state that the

- a. Accountant is **not** aware of any material modifications that should be made to the financial statements for them to be in conformity with GAAP.
- b. Accountant does **not** express an opinion or any other form of assurance on the entity's internal control system.
- c. Accountant has **no** responsibility to update the report for circumstances occurring after the date of the report.
- d. Financial statements present fairly the entity's financial position and the results of its operations and cash flows in conformity with GAAP.

18. Answer (a) is correct because a review report should not mention the change in engagement. Answer (b) is incorrect because no such disclaimer should be included in the review report. Answer (c) is incorrect because the review report should not include the circumstances. Answer (d) is incorrect because the original engagement should not be referred to.

19. Answer (c) is correct because a review consists primarily of such inquiries, analytical procedures and obtaining written representations from management. Answer (a) is incorrect because confirming accounts is not ordinarily a part of a review engagement. Answer (b) is incorrect because a nonissuer review does not ordinarily include such tests of controls. Answer (d) is incorrect because such documentation is not required.

20. Answer (c) is correct because the proper accountant's report does alert readers about the omission and state that those disclosures may influence a user's conclusions. Answer (a) is incorrect because management's justification is not included in the report. Answer (b) is incorrect because the compilation report must indicate that the disclosures are omitted. Answer (d) is incorrect because the financial statements are not considered misleading if the accountant is still involved and has not withdrawn from the engagement.

21. Answer (a) is correct because the report indicates that the accountant is not aware of any material modifications. Answer (b) is incorrect because the internal control system is not referred to. Answer (c) is incorrect because no such statement on updating is included in the report. Answer (d) is incorrect because no such opinion is issued based on a review.

22. According to the AICPA Code of Professional Conduct, which of the following activities results in an act discreditable to the profession?

- a. A CPA solicits recent Uniform CPA Examination questions without written authorization from the AICPA.
- b. A CPA signs a document containing immaterial false and misleading information, or permits or directs another CPA to do so.
- c. A CPA who is engaged to perform a government audit neglects to follow certain government auditing requirements and discloses in the audit report the fact that such requirements were **not** followed and the reasons for it.
- d. A CPA fails to give a client copies of the CPA's workpapers related to a completed and issued work product upon the client's request because the client has **not** paid fees payable to the CPA for the work product.

23. An issuer's auditor is prohibited from providing tax services to which of the following individuals?

- a. The chair of the board of directors.
- b. The chair of the audit committee.
- c. The CEO.
- d. The CFO of an affiliate of the issuer audited by another firm.

24. Each of the following is an ethical principle that should guide the work of auditors in the conduct of audits under government auditing standards, **except**

- a. Materiality.
- b. Integrity.
- c. The public interest.
- d. Proper use of government information.

25. According to the IFAC Code of Ethics for Professional Accountants, audit teams are required to be independent of the audit client during the engagement period and during which other period?

- a. The fiscal year following the period covered by the financial statements.
- b. The period covered by the financial statements.
- c. The calendar years that includes any part of the period covered by the financial statements.
- d. The two years prior to the period covered by the financial statements.

22. Answer (a) is correct because the Acts Discreditable Rule prohibits such disclosures. Answer (b) is incorrect because the information is immaterial. Answer (c) is incorrect because disclosure of the reasons for such neglect is appropriate. Answer (d) is incorrect because working papers are the property of the CPA, who may or may not decide to comply with the client's request.

23. Answer (c) is correct because an issuer's independence is impaired when that auditor provides tax services to individuals in a financial reporting oversight role (this includes the chief executive officer, the president, the chief financial officer and a number of other such professionals). Answer (a) is incorrect because tax services may be provided to a board of director member when that member's only tie to the company is as a member of the board of directors. Answer (b) is incorrect because tax services may be provided to the chair of the audit committee when that individual's only tie to the company is as a member of the board of directors (and its committees, such as the audit committee). Answer (d) is incorrect because tax services may be provided to the CFO of an affiliate that is audited by another firm or an affiliate whose financial statements are not material to the issuer's audited financial statements.

24. Answer (a) is correct because materiality is not an ethical principle under government auditing standards. Answer (b) is incorrect because integrity is an ethical principle under government auditing standards. Answer (c) is incorrect because the public interest is an ethical principle under government auditing standards. Answer (d) is incorrect because proper use of government information is an ethical principle under government auditing standards.

25. Answer (b) is correct because the IFAC Code of Ethics requires audit teams to be independent during both the engagement period and the period covered by the financial statements. Answer (a) is incorrect because independence is not required for the following period (assuming one will not be on the audit team during that period). Answer (c) is incorrect because the fiscal year, not the calendar years are considered. Answer (d) is incorrect because no such two year requirement exists.

26. Reporting standards for financial audits under *Government Auditing Standards* differ from reporting standards under generally accepted auditing standards in that *Government Auditing Standards* require the auditor to

- a. Describe the scope of the auditor's tests of compliance with laws and regulations.
- b. Provide positive assurance that the entity's audit committee is adequately informed about the effects of any illegal acts.
- c. Present the results of the auditor's tests of economy and efficiency regarding the use of the entity's resources.
- d. Provide negative assurance that the auditor discovered no transactions that were indicative of illegal acts.

27. Which of the following procedures would most likely assist an auditor in identifying related party transactions?

- a. Evaluate the reasonableness of management's accounting estimates that are subject to bias.
- b. Retest ineffective internal control activities for evidence of management override.
- c. Review the minutes of the meetings of the board of directors and its committees.
- d. Send second requests for unanswered positive confirmations of accounts receivable.

28. Which of the following factors would most likely influence the form and extent of the auditor's documentation of an entity's internal control environment?

- a. Complexity and size of the entity.
- b. Amount of audit work performed at an interim date.
- c. Amount of audit work performed by the internal auditor.
- d. Results of verifying material account balances.

29. According to the AICPA Code of Professional Conduct, which of the following actions will impair independence?

- a. Preparing client financial statements based on information in a trial balance.
- b. Processing payroll for a client's signature based on client recordkeeping.
- c. Participating in the hiring or termination of a client's employees.
- d. Assisting a client in drafting a stock-offering document or memorandum.

26. Answer (a) is correct because reporting standards for financial audits under *Government Auditing Standards* require the auditor to describe the scope of tests of compliance with laws and regulations. Answer (b) is incorrect because no such positive assurance concerning illegal acts is provided. Answer (c) is incorrect because the results of tests of economy and efficiency are not provided. Answer (d) is incorrect because no such negative assurance is provided.

27. Answer (c) is correct because the minutes of the board of directors and its committees may well include discussion of related party matters. Answer (a) is incorrect because accounting estimates may, but often will not, help auditors to identify related party transactions. Answer (b) is incorrect because evidence on management override does not directly address identifying related party transactions. Answer (d) is incorrect because such confirmations often are not to related parties.

28. Answer (a) is correct because the level of complexity and the size of the entity have a major effect on the form and content of controls related audit documentation; for example, consider the likely difference in documentation between a small retail store and a large international highly diversified company. Answer (b) is incorrect because the amount of work performed at an interim date has a lesser effect on the form and extent of the auditor's documentation than does the correct reply. Answer (c) is incorrect because the amount of work performed by the internal auditor has a lesser effect on the form and extent of the auditor's documentation than does the correct reply. Answer (d) is incorrect because the results of verifying material account balances amount of work performed at an interim date has a lesser effect on the form and extent of the auditor's documentation than does the correct reply.

29. Answer (c) is correct because independence is impaired when a CPA assumes management responsibility (e.g., hiring or terminating client employees). Answer (a) is incorrect because a CPA may prepare client financial statements without impairing independence under the AICPA Code of Professional Conduct (this is not allowed under PCAOB requirements). Answer (b) is incorrect because processing payroll is acceptable under the AICPA Code of Professional Conduct (although signing checks is not). Answer (d) is incorrect because a CPA may assist a client in drafting a stock-offering document or memorandum.

30. When an accountant compiles the financial statements of a nonissuer in accordance with *Statements on Standards for Accounting and Review Services*, the accountant's report should include

- a. A statement that the accountant is **not** aware of material modifications that should be made to the financial statements for them to be in conformity with GAAP.
- b. A statement regarding the accountant's assessment of fraud risk.
- c. A statement that the accountant does **not** express an opinion on the financial statements.
- d. A statement regarding the entity's compliance with laws and regulations.

31. In which of the following circumstances is an auditor most likely to rely on work done by internal auditors?

- a. If financial statement amounts are material and the degree of subjectivity in evaluating the audit evidence is high.
- b. If the internal auditors have concluded that the risk of material misstatement at the overall financial level is negligible.
- c. For financial statement amounts judged by the auditor to require little or **no** subjectively evaluated audit evidence.
- d. For financial statement amounts determined largely or entirely on the basis of estimates made by management.

32. Which of the following statements is correct regarding a management representation letter?

- a. A representation letter can be used in place of specific, previously identified audit procedures.
- b. A representation letter encompasses a different set of assertions than those inherent in the financial statements.
- c. The date of the representation letter should typically be the same as the audit report.
- d. The representations made apply until the date of a client's financial statements.

33. Which of the following components of internal control would be considered the foundation for the other components?

- a. Information and communication.
- b. Risk assessment.
- c. **Control environment.**
- d. Control activities.

34. Which of the following activities by small-business clients best demonstrates management integrity in the absence of a written code of conduct?

- a. **Emphasizing ethical behavior through oral communication and management example.**
- b. Developing and maintaining formal descriptions of accounting procedures.

30. Answer (c) is correct because a compilation report includes a statement that the accountant does not express an opinion on the financial statements. Answer (a) is incorrect because the accountant does not indicate that he or she is not aware of needed material modifications. Answer (b) is incorrect because no statement is included on fraud risk. Answer (d) is incorrect because no statement on compliance with laws and regulations is included.

31. Answer (c) is correct because an external auditor uses more of the work of internal auditors in situations in which low levels of judgement are required. Answer (a) is incorrect because the external auditor is responsible for the overall audit and, therefore, he or she is hesitant to rely on work in very material areas and in situations in which subjectivity is high. Answer (b) is incorrect because the external auditor, not the internal auditors must conclude as to risk. Answer (d) is incorrect because estimates are a risky area which the external auditor will most likely perform.

32. Answer (c) is correct because the representations should be obtained as late as possible in an audit—ordinarily when the auditor has obtained sufficient appropriate audit evidence, the date of the audit report. Answer (a) is incorrect because client representations are not a substitute for other procedures. Answer (b) is incorrect because a different set of assertions is not included in a representation letter. Answer (d) is incorrect because representations must be obtained as of a later date.

33. Answer (c) is correct because the control environment sets the tone of an organization, influencing the control consciousness of is people and, accordingly is the foundation for all the other components. Answer (a) is incorrect because information and communication is less comprehensive than the proper reply. Answer (b) is incorrect because while risk assessment is used to identify and analyze risks, it is less comprehensive than the proper reply. Answer (d) is incorrect because while control activities include the various policies and procedures to help ensure that necessary actions ae taken to address risks, they are less comprehensive than the proper reply.

34. Answer (a) is correct because orally emphasizing ethical behavior and providing examples of such behavior are indicators of management integrity. Answer (b) is incorrect because formal descriptions of accounting procedures may or may not relate to management integrity. Answer (c) is incorrect because narratives may well provide adequate documentation

- c. Documenting internal control procedures using flowcharts rather than narratives.
- d. Reporting regularly to the board of directors about operations and finances.

35. Which of the following procedures would be appropriate to test the existence assertion during an audit of accounts receivable?

- a. Trace transactions from the subsidiary ledger to the general ledger.
- b. Send confirmations to customers.
- c. Trace a sample of invoices to recording in the general ledger.
- d. Determine that all shipments before year end are recorded as sales.

36. A company's management provided its auditors with information concerning litigation, claims, and assessments. Which of the following is the auditor's primary means of corroborating management's information?

- a. Inquiring of company's outside counsel.
- b. Meeting with the company's audit committee.
- c. Meeting with the company's Chairman of the Board.
- d. Inquiring of the company's in-house counsel.

37. Which of the following would cause an auditor of an entity's financial statements to issue either a qualified opinion or a disclaimer of opinion?

- a. Scope limitation involving a recorded uncertainty.
- b. Inadequate disclosure of an uncertainty.
- c. The use of inappropriate accounting principles.
- d. Unreasonable accounting estimates.

38. At the completion of an audit, which of the following entities has ownership of the audit working papers?

- a. The client.
- b. The client's audit committee.
- c. The CPA firm that performed the audit.
- d. The client's stockholders.

39. Which of the following services would constitute a management function under *Government Auditing Standards*, and result in the impairment of a CPA's independence if performed by the CPA?

- a. Developing entity program policies.
- b. Providing methodologies, such as practice guides.
- c. Providing accounting opinions to a legislative body.
- d. Recommending internal control procedures.

and either narratives or flowcharts may have no direct tie to management integrity. Answer (d) is incorrect because while such reporting to the board of directors is desirable, it may or may not relate to management integrity.

35. Answer (b) is correct because confirmations are particularly effective relating to the existence assertion because a respondent acknowledges the information confirmed. Answer (a) is incorrect because tracing from the subsidiary ledger to the general ledger may more directly address the accuracy of posting such transactions. Answer (c) is incorrect because tracing invoices to the general ledger addresses completeness more directly than it does existence. Answer (d) is incorrect because determining that all shipments before year end are recorded as sales addresses completeness more directly than existence.

36. Answer (a) is correct because the client's external counsel is the primary source of such information. Answer (b) is incorrect because while the audit committee may have information on litigation, claims and assessments, one other party ordinarily has more such information. Answer (c) is incorrect because while the chairman of the board may have information on litigation, claims and assessments, one other party ordinarily has more such information. Answer (d) is incorrect because, when possible, the auditor would prefer obtaining such information from a more independent party.

37. Answer (a) is correct because a scope limitation results in either a qualified opinion or a disclaimer, depending upon the pervasiveness of the possible effects of any undetected misstatements. Answer (b) is incorrect because inadequate disclosure of an uncertainty is a departure from GAAP—this will result in either a qualified opinion or an adverse opinion. Answer (c) is incorrect because the use of inappropriate accounting principles is a departure from GAAP—this will result in either a qualified opinion or an adverse opinion. Answer (d) is incorrect because unreasonable accounting estimates are departures from GAAP—this will result in either a qualified opinion or an adverse opinion.

38. Answer (c) is correct because the CPA firm owns the working papers at all times, not just at completion of an audit. Answer (a) is incorrect because while the client owns the accounting records, it does not own the audit working papers. Answer (b) is incorrect because the client's audit committee does not own the working papers. Answer (d) is incorrect because the client's stockholders do not own the working papers.

39. Answer (a) is correct because developing entity program policies is considered a management function under *Government Auditing Standards* (the "yellow book"). Answer (b) is incorrect because providing methodologies such as practice guides is not considered a management function. Answer (c) is incorrect because a CPA may provide such accounting opinions and this would not constitute a management function. Answer (d) is incorrect because recommending internal control procedures, in itself, is not considered a management function; accepting responsibility for designing, implementing or maintaining internal control would be considered a management function.

40. Which of the following best characterizes an auditor's exercise of professional skepticism?

- a. Conducting all fraud-related inquiries in a non-confrontational manner.
- b. Obtaining adequate conclusive evidence in support of the fairness of the financial statements.
- c. Having an attitude that includes a questioning mind.
- d. Taking into account past relationships and experiences with management.

41. Before accepting an engagement to compile or review the financial statements of a nonissuer, which of the following specific inquiries should a successor accountant consider making to the predecessor accountant?

- a. How cooperative was the owner's lawyer in providing a legal opinion?
- b. How did you assess inherent risk and control risk?
- c. How would you describe the integrity of the owner?
- d. What evaluation did you make of any accounting estimates?

42. An entity has failed to provide documentation for a newly acquired material asset and informs its auditors that the documentation is lost. According to generally accepted government auditing standards what would this situation typically indicate to the auditors?

- a. Fraudulent activity.
- b. Abusive activity.
- c. Misappropriation of assets.
- d. A heightened risk of fraud.

43. An accountant performing a compilation for a nonissuer believes that the financial statements might be materially misstated. The client refuses to provide additional or revised information. How should the accountant respond?

- a. By requesting that the engagement be changed from a compilation to a review or audit.
- b. By issuing a compilation report that is qualified for a scope limitation.
- c. By withdrawing from the compilation engagement.
- d. By issuing an adverse report on the compilation.

44. During an audit of a nonissuer's financial statements, an auditor should perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if

- a. The auditor does **not** presume that client management has committed fraud.
- b. More financial documentation is available through tests of controls.
- c. Substantive procedures alone **cannot** provide sufficient appropriate audit evidence.
- d. The auditor does **not** intend to rely on the operating effectiveness of controls.

40. Answer (c) is correct because professional skepticism is an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence. Answer (a) is incorrect because while conducting fraud-related inquiries in a non-confrontational manner may be desirable, it does not directly relate to professional skepticism. Answer (b) is incorrect because this is not how professional skepticism is defined and because auditors seldom are able to obtain "conclusive evidence." Answer (d) is incorrect because while an auditor will consider past relationships and experiences with management, it is much less complete than the proper reply.

41. Answer (c) is correct because a successor will inquire of such major issues as management integrity. Answer (a) is incorrect because no such inquiry concerning the owner's lawyer is made since neither a compilation nor a review ordinarily includes contacting that attorney. Answer (b) is incorrect because no such assessment is required when performing a compilation or review. Answer (d) is incorrect because no such inquiry concerning accounting estimates is ordinarily included.

42. Answer (d) is correct because while the failure to provide documentation is consistent with fraud, it is also consistent with simply losing certain documents; thus there is a heightened risk of fraud, but fraud may or may not be the explanation for the lack of documentation. Answer (a) is incorrect because it is uncertain as to whether fraudulent activity is present. Answer (b) is incorrect because an abusive activity may or may not be present. Answer (c) is incorrect because misappropriation may or may not be involved.

43. Answer (c) is correct because when such information seems incomplete or otherwise unsatisfactory, and the client refuses to modify it, the professional standards state that the accountant should withdraw from the engagement. Answer (a) is incorrect because changing the engagement will not eliminate the situation as the financial statements still might be materially misstated. Answer (b) is incorrect because qualified opinions are only issued based on audits, not compilations or reviews. Answer (d) is incorrect because adverse opinions are only issued based on audits, not compilations or reviews.

44. Answer (c) is correct because when substantive procedures alone cannot provide sufficient appropriate audit evidence, the auditor will need to perform tests of controls. Answer (a) is incorrect because the decision to perform tests of controls isn't ordinarily tied to a presumption that management has not committed fraud. Answer (b) is incorrect because the level of documentation available doesn't determine whether tests of controls are performed. Answer (d) is incorrect because tests of controls are performed when an auditor intends to rely on the operating effectiveness of controls, not on when the auditor does not intend to so rely.

45. In performing interviews and examining documents related to preliminary work in a financial statement audit of a nonissuer, an auditor identifies a business risk associated with plans for a new product line. What should the auditor do as a result?

- a. Modify the scope of the engagement to include an analysis of the budget for the new product line and consider the new risk in conjunction with other risks after the budget items have been analyzed.
- b. Analyze the newly identified risk in conjunction with economic circumstances related exclusively to the new product line and consider whether there is an immediate consequence for the risk of material misstatement for affected classes of transactions.
- c. Modify the financial statement disclosures to include the newly identified risk if it is likely that the new product line will have an adverse effect on the company's profitability.
- d. Analyze the newly identified risk in conjunction with other known business risks and consider whether there is an immediate consequence for the risk of material misstatement at various levels of the audit.

46. If interim substantive procedures for an account identified no exceptions, which of the following would the auditor not perform on that account at year end?

- a. Tests of details for the entire year under audit.
- b. Tests of details of activity during the period since the interim testing date.
- c. Reconciliation of year-end balances to interim balances.
- d. Substantive analytical procedures of the period since the interim testing date.

47. In communicating with those charged with governance, the auditor must decide whether to communicate with the audit committee or the client's entire board of directors. Which of the following considerations will be least relevant to this decision?

- a. Whether the audit committee will be able to provide further information and explanations that the auditor may require while performing the audit.
- b. The nature of the matters to be communicated.
- c. Management's preference.
- d. Regulatory requirements related to audit communications with those charged with governance.

48. According to the Sarbanes-Oxley Act of 2002, the PCAOB has the legal authority to perform each of the following, except:

- a. Prosecute suspected criminal violations by registered public accounting firms.
- b. Process, review, and approve the registration of public accounting firms that audit issuers.
- c. Inspect and review selected audit engagements of registered public accounting firms.
- d. Establish auditing, quality control, and independence standards for audits of issuers.

45. Answer (d) is correct because the newly identified information should be considered in conjunction with information on other known business risks. Answer (a) is incorrect because the scope of the audit may or may not have to be modified. Answer (b) is incorrect because the auditor should consider other factors related to the new product line. Answer (c) is incorrect because the new product line may not require financial statement disclosures.

46. Answer (a) is correct because the interim tests, which identified no exceptions, already included much of the year's work. Answer (b) is incorrect because the emphasis of testing will be on activity since the interim testing date. Answer (c) is incorrect because such reconciliation is appropriate. Answer (d) is incorrect because substantive analytical procedures represent a possible approach for the period since the interim testing date.

47. Answer (c) is correct because management's preference is not particularly relevant; most relevant is determining those charged with governance since that is the target group for the communication. Answer (a) is incorrect because the audit committee may be able to provide important information to the auditor during the audit. Answer (b) is incorrect because not all matters are relevant to those charged with governance. Answer (d) is incorrect because regulatory requirements should be followed.

48. Answer (a) is correct because the PCAOB does not have the authority to prosecute suspected criminal violations by registered CPA firms. Answer (b) is incorrect because the PCAOB is involved with the registration of public accounting firms that audit issuers. Answer (c) is incorrect because the PCAOB does perform such inspections. Answer (d) is incorrect because the PCAOB may establish auditing, quality control, and independence standards for audits of issuers.

49. Which of the following best describes the effect of a contingent fee arrangement on the auditor's independence?

- a. The contingent fee arrangement does **not** impair independence if it is consistent with the registered public accounting firm's quality control policies.
- b. The contingent fee arrangement impairs independence.
- c. The contingent fee arrangement does **not** impair independence **unless** more than half of the fee is subject to contingencies.
- d. The contingent fee arrangement impairs independence **unless** approved by the client's audit committee.

50. An accountant is engaged to perform compilation services for a new client in an industry with which the accountant has no previous experience. How should the accountant obtain sufficient knowledge of the industry to perform the compilation service?

- a. By obtaining the most recent letter of credit from the entity's primary financial institution.
- b. By consulting AICPA guides, industry publications, or individuals knowledgeable about the industry.
- c. By researching the entity's Internet site and searching for current press releases.
- d. By reviewing the predecessor accountant's workpapers without the knowledge of the entity.

49. Answer (b) is correct because any contingent fee arrangement impairs auditor independence. Answer (a) is incorrect because a contingent fee arrangement does impair independence, regardless of quality control practices. Answer (c) is incorrect because a contingent fee impairs independence, regardless of its amount. Answer (d) is incorrect because a contingent fee impairs independence even if approved by the client's audit committee.

50. Answer (b) is correct because an accountant can obtain the needed industry knowledge by consulting AICPA guides, industry publications, or individuals knowledgeable about the industry. Answer (a) is incorrect because a letter of credit will not provide the industry information needed. Answer (c) is incorrect because the Internet site and current press releases are likely to provide more information on the company itself, as contrasted to the industry. Answer (d) is incorrect because a successor only reviews a predecessor accountant's workpapers after a client has agreed to allow such a review.