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Sections

Group Exam A

QUESTION 1
Several sources of GAAP consulted by an auditor are in conflict as to the application of an accounting principle. Which of the following should the auditor consider the most authoritative?

A. FASB Technical Bulletins.
B. AICPA Accounting Interpretations.
C. FASB Statements of Financial Accounting Concepts.
D. AICPA Technical Practice Aids.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. In accordance with the GAAP hierarchy, FASB Technical Bulletins are considered the most authoritative of the sources listed in the question.
Choice "b" is incorrect. Of the sources listed, AICPA Accounting Interpretations would be considered the second most authoritative.
Choice "c" is incorrect. FASB Statements of Financial Accounting Concepts are among the least authoritative sources of GAAP available to auditors. Choice "d" is incorrect. AICPA Technical Practice Aids are among the least authoritative sources of GAAP available to auditors.

QUESTION 2
For an entity's financial statements to be presented fairly in conformity with generally accepted accounting principles, the principles selected should:

A. Be applied on a basis consistent with those followed in the prior year.
B. Be approved by the Auditing Standards Board or the appropriate industry subcommittee.
C. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
D. Match the principles used by most other entities within the entity's particular industry.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. Financial statements are presented fairly in conformity with GAAP when there are no material misstatements included therein. The fact that there may occasionally be immaterial misstatements means that the financial statements are correct "within a range of acceptable limits."
Choice "a" is incorrect. Accounting principles may change from year to year. As long as such changes are properly accounted for, the financial statements are still in conformity with GAAP.
Choice "b" is incorrect. The AICPA and the FASB determine GAAP, not the Auditing Standards Board.
Choice "d" is incorrect. There is no requirement that an entity's financial statements be prepared in accordance with prevalent industry practices in order to be in conformity with GAAP.

QUESTION 3
Which of the following statements is correct concerning an auditor's responsibilities regarding financial statements?

A. An auditor may not draft an entity's financial statements based on information from management's accounting system.
B. The adoption of sound accounting policies is an implicit part of an auditor's responsibilities.
C. An auditor's responsibilities for audited financial statements are confined to the expression of the auditor's opinion.
D. Making suggestions that are adopted about an entity's internal control environment impairs an auditor's independence.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. An auditor's responsibility is to express an opinion on financial statements based on an audit.
Choice "a" is incorrect. An auditor may draft an entity's financial statements based on information from management's financial system. This would be referred to as a compilation engagement. Choice "b" is incorrect. The adoption of sound accounting policies is an implicit part of management's responsibilities, not the auditor's responsibilities. Choice "d" is incorrect. An auditor often makes suggestions that are adopted about an entity's internal control environment.

QUESTION 4
Which of the following provides the most authoritative guidance for an auditor?

A. An AICPA audit and accounting guide that provides specific guidance with respect to the accounting practices in the client's industry.
B. A Journal of Accountancy article discussing implementation of a new standard.
C. General guidance provided by a Statement on Auditing Standards.
D. Specific guidance provided by an interpretation of a Statement on Auditing Standards.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. General guidance provided by a Statement on Auditing Standards is the most authoritative of level of auditing guidance. Auditors are required to comply with SASs, and should be prepared to justify any departures therefrom.
Choices "a" and "d" are incorrect. AICPA audit and accounting guides and SAS interpretations are interpretive publications that provide guidance regarding how SASs should be applied in specific situations. They are not as authoritative as SASs.
Choice "b" is incorrect. Journal of Accountancy articles have no authoritative status but may be helpful to the auditor.

QUESTION 5
Which of the following accurately depicts the auditor's responsibility with respect to Statements on Auditing Standards?

A. The auditor is required to follow the guidance provided by the Standards, without exception.
B. The auditor is generally required to follow the guidance provided by Standards with which he or she is familiar, but will not be held responsible for departing from provisions of which he or she was unaware.
C. The auditor is generally required to follow the guidance provided by the Standards, unless following such guidance would result in an audit that is not cost-effective.
D. The auditor is generally required to follow the guidance provided by the Standards, and should be able to justify any departures.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The auditor is generally required to follow the guidance provided by the Standards, and should be able to justify any departures.
Choice "a" is incorrect. On rare occasions, the auditor may depart from the guidance provided by the SASs, but he or she must justify such departures.
Choice "b" is incorrect. Lack of familiarity with a SAS is not a valid reason for departing from its guidance.
The auditor is expected to have sufficient knowledge of the SASs to identify those that are applicable to a given audit engagement.
Choice "c" is incorrect. The cost associated with following the guidance provided by a SAS is not an acceptable reason for departing from its guidance.

QUESTION 6
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.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods.
Since the auditor has gathered sufficient evidence about consistency, no reference need be made in the report.
Choice "a" is incorrect. If the auditor is able to obtain sufficient evidence about consistency, the auditor may report on the entity's financial statements.
Choice "c" is incorrect. The consistency standard is one of the ten GAAS, and it does apply to this audit.
Choice "d" is incorrect. If the auditor is able to obtain sufficient evidence about consistency, no mention of consistency need be made. Consistency is implied in the standard report.

QUESTION 7
The third general standard states that due care is to be exercised in the performance of an audit. This standard is ordinarily interpreted to require:

A. Thorough review of the existing safeguards over access to assets and records.
B. Limited review of the indications of employee fraud and illegal acts.
C. Objective review of the adequacy of the technical training and proficiency of firm personnel.
D. Critical review of the judgment exercised at every level of supervision.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The third general standard of due care is ordinarily interpreted to require critical review of the judgment exercised at every level of supervision, and the judgment exercised by those assisting in the audit. Choice "a" is incorrect. The third general standard of due care does not require a

thorough review of the existing safeguards over access to assets and records.
Choice "b" is incorrect. The standard of due care does not specifically require a limited review of the indications of employee fraud and illegal acts. Choice "c" is incorrect. The standard of due care does not require a review of audit staff training and proficiency.

QUESTION 8
The concept of materiality would be least important to an auditor when considering the:

A. Adequacy of disclosure of a client's illegal act.
B. Discovery of weaknesses in a client's internal control.
C. Effects of a direct financial interest in the client on the CPA's independence.
D. Decision whether to use positive or negative confirmations of accounts receivable.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. Any direct financial interest in a client impairs independence, even if it is immaterial.
Choice "a" is incorrect. A material illegal act may require disclosure in or adjustment to the financial statements, whereas an immaterial illegal act may not require disclosure.
Choice "b" is incorrect. A material weakness in internal control will affect the nature, timing, and extent of audit procedures, whereas an immaterial weakness in internal control may have little impact on the audit. Choice "d" is incorrect. An auditor is likely to use positive confirmations for material accounts receivable, but may consider negative confirmations for immaterial receivable balances.

QUESTION 9
An auditor of a nonpublic company must conduct the audit in accordance with:
I. ASB standards.
II. PCAOB standards.

A. I.
B. Both I and II.
C. Either I or II, but not both.
D. II.

Correct Answer: A
Section: Volume A

Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. An auditor of a nonpublic company must conduct the audit in accordance with ASB standards.
Choice "b" is incorrect. An auditor of a nonpublic company is not required to conduct the audit in accordance with PCAOB standards.
Choice "c" is incorrect. While an auditor is only required to conduct the audit in accordance with ASB standards, the auditor may choose to follow PCAOB standards as well. Choice "d" is incorrect. An auditor of a nonpublic company is not required to conduct the audit in accordance with PCAOB standards.

QUESTION 10
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.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. The auditor should plan and perform the audit with an attitude of professional skepticism. This attitude includes a questioning mind and a critical assessment of audit evidence. Choices "a", "b", and "d" are incorrect. Objectivity, independence, integrity, and impartiality are basic ethical characteristics and professional qualities embodied in the general standards.

QUESTION 11
Which of the following is not an example of the application of professional skepticism?

A. Designing additional auditing procedures to obtain more reliable evidence in support of a particular financial statement assertion.
B. Obtaining corroboration of management's s through consultation with a specialist.
C. Inquiring of prior year engagement personnel regarding their assessment of management's honesty and integrity.
D. Using third party confirmations to provide support for management's representations.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. The auditor should consider that fraud might occur regardless of any past experience with the entity. An assessment of management's honesty and integrity performed during the previous year would not necessarily be relevant to the current year's audit.
Choice "a" is incorrect. An auditor might apply professional skepticism by performing additional audit procedures designed to improve the reliability of evidence.
Choice "b" is incorrect. Corroborating management's s is an example of the application of professional skepticism, since the auditor is obtaining additional support rather than simply accepting the as given. Choice "d" is incorrect. Using third party confirmations to provide support for management's representations is an example of the application of professional skepticism, since the auditor is obtaining additional support rather than simply accepting the as given.

QUESTION 12
Which of the following categories is included in generally accepted auditing standards?

A. Standards of review.
B. Standards of planning.
C. Standards of fieldwork.
D. Standards of evidence.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. Generally accepted auditing standards include three categories: general standards, standards of fieldwork, and standards of reporting.
Choices "a", "b", and "d" are incorrect, based on the above .

QUESTION 13
When qualifying an opinion because of an insufficiency of audit evidence, an auditor should refer to the situation in the:

	Scope paragraph	Notes to the financial statements
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. When a qualified opinion is issued due to a lack of sufficient audit evidence, the lack of evidence should be disclosed in an explanatory paragraph before the opinion paragraph. Since insufficient evidence is a scope limitation, the scope paragraph should also be modified to refer to the limitation and to the explanatory paragraph that discusses it.
Choices "a" and "c" are incorrect. Management (and not the auditor) prepares the notes to the financial statements. The auditor therefore would not refer to this (or any other) situation in the notes to the financial statements. Choice "d" is incorrect. The auditor does refer to the situation in the scope paragraph.

QUESTION 14
When an auditor believes there is substantial doubt about the ability of an entity to continue as a going concern, all of the following should be included in the audit documentation, except:

A. The conditions that gave rise to the substantial doubt.
B. The auditor's conclusion about whether substantial doubt remains or is alleviated.
C. Management's conclusion regarding whether substantial doubt remains or is alleviated.
D. The effect of the auditor's conclusion on the auditor's report.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. Whether substantial doubt remains or is alleviated is a judgment call made by the auditor, and there is no requirement to document management's opinion on the matter.
Choices "a", "b", and "d" are incorrect. When an auditor believes there is substantial doubt about the ability of an entity to continue as a going concern, the conditions that gave rise to the substantial doubt, the auditor's conclusion about whether substantial doubt remains or is alleviated, and the effect of the auditor's conclusion on the auditor's report should all be documented.

QUESTION 15
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:

A. Increase current dividend distributions.
B. Reduce existing lines of credit.
C. Increase ownership equity.
D. Purchase assets formerly leased.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. The auditor considers any of management's plans that might serve to mitigate the adverse effects of particular conditions and events. Typically, plans to increase ownership equity, to borrow money, to restructure debt, to sell assets, and/or to reduce or delay expenditures might all be considered mitigating factors.
Choices "a", "b", and "d" are incorrect. Increasing dividend distributions, reducing lines of credit, and purchasing assets would not improve a weak cash flow situation.

QUESTION 16
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.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. Inadequate disclosure of the substantial doubt about an entity's ability to continue as a going concern is a departure from GAAP, resulting in either a qualified or adverse opinion. Choices "a" and "d" are incorrect. Scope limitations result in either a qualified opinion or in a disclaimer of opinion, but not in an adverse opinion.
Choice "c" is incorrect. A change in accounting principle results in a modified unqualified report, as long as the change was accounted for properly.

QUESTION 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?

A. Significant related party transactions are pervasive.
B. Usual trade credit from suppliers is denied.
C. Arrearages in preferred stock dividends are paid.
D. Restrictions on the disposal of principal assets are present.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. Indications of possible financial difficulties, such as denial of usual trade credit from suppliers, may cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.
Choice "a" is incorrect. The existence of related parties and the occurrence of related party transactions do not indicate doubt about the entity's ability to continue as a going concern.
Choice "c" is incorrect. Payment of preferred stock dividends in arrears might very well indicate an improvement in the entity's financial situation. It is the lack of payment of preferred, cumulative dividends (a possible indication of financial difficulty) that might cause an auditor to have substantial doubt about an entity's

ability to continue as a going concern.
Choice "d" is incorrect. Restrictions on the disposal of assets might limit the options available to management as far as mitigating adverse conditions, but it would not in and of itself cause the auditor to have substantial doubt about an entity's ability to continue as a going concern.

QUESTION 18
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 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.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Since the auditor was unable to gather sufficient evidence on the beginning balances of the balance sheet accounts, the auditor would be unable to express an opinion on the current year's results of operations and cash flows. The auditor could express an opinion on the statement of financial position.
Choice "b" is incorrect. Since the scope limitation could have a pervasive effect on the financial statements (affecting all assets and liabilities), a disclaimer of opinion (and not merely a qualified opinion) is required on the income statement and statement of cash flows. An opinion may be expressed on the year-end statement of financial position.
Choice "c" is incorrect. The auditor does not need to withdraw from the engagement and refuse to be associated with the financial statements. Choice "d" is incorrect. An uncertainty does not exist. The auditor can express an opinion on one of the financial statements.

QUESTION 19
Pell, CPA, decides to serve as principal auditor in the audit of the financial statements of Tech
Consolidated, Inc. Smith, CPA, audits one of Tech's subsidiaries. In which situation(s) should Pell make reference to Smith's audit?
I. Pell reviews Smith's audit documentation and assumes responsibility for Smith's work, but expresses a qualified opinion on Tech's financial statements.
II. Pell is unable to review Smith's audit documentation; however, Pell's inquiries indicate that Smith has an excellent reputation for professional competence and integrity.

A. I only.
B. II only.

C. Both I and II.
D. Neither I nor II.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The principal auditor makes reference in the audit report to the work of the other auditor when the principal auditor is unable to review the other auditor's audit documentation. This is because the principal auditor will be unable to be satisfied concerning the work performed by the other auditor. Even though the other auditor has an excellent reputation, the principal auditor must see the work to be able to assume responsibility for it.
Choice "a" is incorrect. When the principal auditor decides to assume responsibility for the work of the other independent auditor, no reference is made to the work of the other auditor, regardless of the type of audit report expressed.
Choice "c" is incorrect. When the principal auditor decides to assume responsibility for the work of the other independent auditor, no reference is made to the work of the other auditor, regardless of the type of audit report expressed. Choice "d" is incorrect. The principal auditor will make reference in the audit report to the work of the other auditor when the principal auditor is unable to review the other auditor's audit documentation. This is because the principal auditor will be unable to be satisfied concerning the work performed by the other auditor. Even though the other auditor has an excellent reputation, the principal auditor must see the work to be able to assume responsibility for it.

QUESTION 20
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:

A. Discuss with lenders the terms of all debt and loan agreements.
B. Strengthen internal controls over cash disbursements.
C. Purchase production facilities currently being leased from a related party.
D. Postpone expenditures for research and development projects.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. When assessing management's plans for dealing with the adverse effects of future conditions and events, mitigating factors would include:
1. The postponement of expenditures (including R&D),

2. Plans to dispose of assets,
3. Plans to borrow money or restructure debt,
4. Plans to increase ownership equity (sell stock).

Choice "a" is incorrect. Discussions with lenders regarding terms would not be a mitigating factor. Actual agreements regarding restructuring of debt or amendments to covenants would be required. Choice "b" is incorrect. Strengthening internal controls over cash would not qualify as a management tactic to address going concern issues. Choice "c" is incorrect. Purchasing facilities which are currently being leased would only further decrease cash flow.

QUESTION 21
Which of the following statements is a basic element of the auditor's standard report?

A. The disclosures provide reasonable assurance that the financial statements are free of material misstatement.
B. The auditor evaluated the overall internal control.
C. An audit includes assessing significant estimates made by management.
D. The financial statements are consistent with those of the prior period.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. The auditor's standard audit report includes a statement that "An audit includes assessing...significant estimates made by management..."
Choice "a" is incorrect. The standard audit report does not state that disclosures provide reasonable assurance that the financial statements are free of material misstatement. The correct statement is:
"...standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement."
Choice "b" is incorrect. The standard audit report does not state that the auditor evaluated the overall internal control. The correct statement is "An audit includes...evaluating the overall financial statement presentation." Internal control is not mentioned in the standard audit report.
Choice "d" is incorrect. The standard audit report does not state "The financial statements are consistent with those of the prior period." According to the second standard of reporting, consistency is implicitly reported. Only if there is an inconsistency is an explicit statement included.

QUESTION 22
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.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. If the auditor lacks independence with respect to an audit client, the auditor must disclaim an opinion on the financial statements. A qualified opinion is not an option. Choice "a" is incorrect. A departure from GAAP (which is not sufficiently material to warrant an adverse opinion) may justify a qualification of the auditor's report.
Choice "c" is incorrect. A scope limitation may result in a qualified opinion or a disclaimer of opinion.
Choice "d" is incorrect. The auditor's report may make reference to the use of a specialist only if the specialist's findings result in a change to the auditor's report, such as a qualified opinion.

QUESTION 23
An auditor most likely would express an unqualified opinion and would not add explanatory language to the report if the auditor:

A. Wishes to emphasize that the entity had significant transactions with related parties.
B. Concurs with the entity's change in its method of computing depreciation.
C. Discovers that supplementary information required by FASB has been omitted.
D. Believes that there is a probable likelihood of a material loss resulting from an uncertainty that is sufficiently supported and disclosed.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. An auditor most likely would express an unqualified opinion and would not add explanatory language to the report if the auditor believes that there is a probable likelihood of a material loss resulting from an uncertainty that is sufficiently supported and disclosed.
Choice "a" is incorrect. Emphasis of a matter, such as the existence of significant transactions with related parties, may result in an additional explanatory paragraph appended to an otherwise unqualified opinion.
Choice "b" is incorrect. A change in accounting principle does result in an additional explanatory paragraph appended to an otherwise unqualified opinion.
Choice "c" is incorrect. Omission of supplemental information required by GAAP does result in an additional explanatory paragraph appended to an otherwise unqualified opinion.

QUESTION 24
An auditor would express an unqualified opinion with an explanatory paragraph added to the auditor's report for:

	An unjustified accounting change	A material weakness in internal control
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. An unjustified accounting change may cause the auditor to issue a qualified or adverse opinion. A material weakness must be reported to management and those charged with governance, but would not be disclosed in an explanatory paragraph appended to an otherwise unqualified opinion.
Choices "a", "b", and "c" are incorrect, as per the above .

QUESTION 25
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. Unqualified opinion.
B. Opinion qualified because of a lack of consistency.
C. Opinion qualified because of a departure from GAAP.
D. Adverse opinion.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. GAAP allows a company to use different methods for costing different inventories as long as the methods are disclosed. Thus, the audit report would be unqualified; there is no departure from GAAP.
Choice "b" is incorrect. The consistency standard refers to changes in application of accounting practices between periods, affecting the comparability of financial statements. There is no indication Digit made any change in methods. Choice "c" is incorrect. Use of different methods for costing inventory is permissible under GAAP, and would not result in a qualification of the auditor's report. Choice "d" is incorrect. Use of different methods for costing inventory is permissible under GAAP, and would not result in an adverse report.

QUESTION 26
In which of the following circumstances would an auditor not express an unqualified 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.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The inability to obtain audited financial statements of a consolidated investee represents a scope limitation which may result in either a qualified opinion or a disclaimer of opinion.
Choice "a" is incorrect. A material change in accounting principles between periods is disclosed in an explanatory paragraph added to an otherwise unqualified opinion.
Choice "b" is incorrect. Omission of selected quarterly data required by SEC regulations is disclosed in an explanatory paragraph added to an otherwise unqualified opinion. Choice "c" is incorrect. Emphasis of a matter is disclosed in an explanatory paragraph added to an otherwise unqualified opinion.

QUESTION 27
Management of Edgington Industries plans to disclose an uncertainty as follows:
The Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming damages. Discovery proceedings are in progress. The

ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.
The auditor is satisfied that sufficient audit evidence supports management's assertions about the nature and disclosure of the uncertainty. What type of opinion should the auditor express under these circumstances?

A. Unqualified without an explanatory paragraph.
B. "Subject to" qualified.
C. "Except for" qualified.
D. Disclaimer of opinion.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The note presented describes an uncertainty that is properly discloseD. An explanatory paragraph is not required in the unqualified opinion.
Choice "b" is incorrect. A "subject to" qualified opinion should never be issued.
Choice "c" is incorrect. Since the auditor is satisfied that the assertion and disclosure are supported by the existing evidence, a qualified opinion is not required.
Choice "d" is incorrect. Since the auditor is satisfied that the assertion and disclosure are supported by the existing evidence, there is no need for the auditor to disclaim an opinion.

QUESTION 28
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 an explanatory paragraph that specifically uses the phrase (s):

	"Possible discontinuance of operations"	"Reasonable period of time, not to exceed one year"
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion. This conclusion should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms "substantial doubt" and "going concern"]. The "reasonable period...not to exceed one year" is inherent in the definition of going concern and is not explicitly stated in the audit report. The phrase "possible discontinuation of operations" may be included in the going concern disclosure but is not specifically required. Choices "a", "b", and "c" are incorrect, as per the above .

QUESTION 29
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, 19X4. That doubt has been removed in 19X5. What is Mead's reporting responsibility if Tech is presenting its financial statements for the year ended June 30, 19X5, on a comparative basis with those of 19X4?

A. The explanatory paragraph included in the 19X4 auditor's report should not be repeated.
B. The explanatory paragraph included in the 19X4 auditor's report should be repeated in its entirety.

C. A different explanatory paragraph describing Mead's reasons for the removal of doubt should be included.
D. A different explanatory paragraph describing Tech's plans for financial recovery should be included.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. If substantial doubt about the entity's ability to continue as a going concern has been removed in the current period, the explanatory paragraph included in the prior period auditor's report should not be repeated, and no description of the reasons or plans for recovery need be included.
Choice "b" is incorrect. If doubt about the going concern assumption has been removed in the current period, it is not appropriate to include the explanatory paragraph from the prior year in the auditor's report for the current year.
Choice "c" is incorrect. If doubt about the going concern assumption has been removed in the current period, no explanatory paragraph is required since the situation no longer exists. The auditor does not have to explain the reason for the change.
Choice "d" is incorrect. If doubt about the going concern assumption has been removed in the current period, no explanatory paragraph is required since the situation no longer exists. The entity does not have to describe its plans for the future.

QUESTION 30
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.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The auditors should address their report to the entity that engaged them. In this case, Monday Corp. engaged the auditor to perform an

acquisition audit and the report should be addressed to Monday.
Choice "b" is incorrect. Wall Corp. did not engage the auditors and thus the report should not be addressed to them.
Choices "c" and "d" are incorrect. Even though the bank will be relying on the audited financial statements in determining whether to make the loan, the bank did not directly engage the auditing firm and accordingly, the report should not be addressed to them.

QUESTION 31
An auditor issued an audit report that was dual dated for a subsequent event occurring after the original date of the auditor's report but before issuance of the related financial statements. The auditor's responsibility for events occurring subsequent to the original report date was:

A. Limited to include only events occurring up to the date of the last subsequent event referenced.
B. Limited to the specific event referenced.
C. Extended to subsequent events occurring through the later date.
D. Extended to include all events occurring since the original report date.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. When an auditor issues a report that is dual dated for a subsequent event occurring after the original date of the auditor's report, but before issuance of the related financial statements, the auditor's responsibility for events occurring subsequent to the original report date is limited to the specific event referenced.
Choices "a", "c", and "d" are incorrect. The auditor takes responsibility for only the specific event noted in the dual dating and no other event occurring subsequent to the original report date.

QUESTION 32
When an independent CPA is associated with the financial statements of a publicly held entity but has not audited or reviewed such statements, the appropriate form of report to be issued must include a(an):

A. Regulation S-X exemption.
B. Report on pro forma financial statements.
C. Unaudited association report.
D. Disclaimer of opinion.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. When an accountant is associated with the financial statements of a public entity, but has not audited or reviewed such statements, the accountant must issue a report disclaiming any opinion on the statements. Choices "a", "b", and "c" are incorrect since a disclaimer is required in this case.

QUESTION 33
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.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. Confirming with third parties the details of arrangements to provide or "maintain (needed) financial support" is an audit procedure that may identify doubts about an entity's ability to continue as a going concern.
Choice "a" is incorrect. Inspecting title documents provides evidence of ownership of assets but would not necessarily identify conditions affecting an entity's ability to continue as a going concern.
Choice "c" is incorrect. Reconciling the cash balance per books with the cut-off bank statement and the bank confirmation provides evidence of completeness and valuation, but would not necessarily identify conditions affecting an entity's ability to continue as a going concern.
Choice "d" is incorrect. Comparing an entity's policies to other entities in the industry would not necessarily identify conditions affecting an entity's ability to continue as a going concern.

QUESTION 34
When an independent CPA assists in preparing the financial statements of a publicly held entity, but has not audited or reviewed them, the CPA should issue a disclaimer of opinion. In such situations, the CPA has no responsibility to apply any procedures beyond:

A. Documenting that internal control is not being relied on.
B. Reading the financial statements for obvious material misstatements.
C. Ascertaining whether the financial statements are in conformity with GAAP.

D. Determining whether management has elected to omit substantially all required disclosures.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The accountant is only required to read the financial statements for obvious material misstatements.
Choice "a" is incorrect. The accountant need not document that internal control is not being relied on.
Choices "c" and "d" are incorrect. The accountant is not required to evaluate conformity with GAAP, but any known departures (including inadequate disclosure) should be described in the disclaimer.

QUESTION 35
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:

A. Issue a qualified or adverse opinion, depending upon materiality, due to the possible effects on the financial statements.
B. Consider the adequacy of disclosure about the client's possible inability to continue as a going concern.
C. Report to the client's audit committee that management's accounting estimates may need to be adjusted.
D. Reissue the prior year's auditor's report and add an explanatory paragraph that specifically refers to "substantial doubt" and "going concern."

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. When an auditor concludes there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, the auditor's responsibility is to consider the adequacy of disclosure about the entity's possible inability to continue as a going concern and include an explanatory paragraph in the audit report.
Choice "a" is incorrect. The auditor would include an explanatory paragraph following the unqualified opinion, or disclaim an opinion due to a material uncertainty. A qualified or adverse opinion is not appropriate for doubt about an entity's ability to continue as a going concern.
Choice "c" is incorrect. Management's accounting estimates are unrelated to going concern issues.
Choice "d" is incorrect. Going concern issues are considered prospectively. It is not appropriate to reissue a prior audit report if doubt arises about an entity's ability to continue in a future period.

QUESTION 36

Reference in a principal auditor's report to the fact that part of the audit was performed by another auditor most likely would be an indication of the:

A. Divided responsibility between the auditors who conducted the audits of the components of the overall financial statements.
B. Lack of materiality of the portion of the financial statements audited by the other auditor.
C. Principal auditor's recognition of the other auditor's competence, reputation, and professional certification.
D. Different opinions the auditors are expressing on the components of the financial statements that each audited.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Reference to another auditor indicates division of responsibility for the audits of the components of the overall financial statements.
Choice "b" is incorrect. Reference to another auditor would not generally be made if the other auditor's portion of the financial statements were immaterial.
Choice "c" is incorrect. The reference in the report is not meant to recognize the qualifications of the other auditor, but simply to divide the responsibility between the two auditors. Choice "d" is incorrect. The reference to the other auditor would be made regardless of what type of opinion is expressed by each auditor.

QUESTION 37
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 ."
D. Is appropriate and would not negate the unqualified opinion.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Emphasis of a matter should be disclosed in an explanatory paragraph appended to an otherwise unqualified opinion.
Choice "a" is incorrect. An "except for" qualification is used for a scope limitation or a departure from GAAP, but not for emphasis of a matter.
Choice "b" is incorrect. The auditor may emphasize a matter even if it is included in the footnotes.

Choice "c" is incorrect. A phrase such as "with the foregoing " should not be used in an unqualified opinion.

QUESTION 38
When there has been a change in accounting principles, but the effect of the change on the comparability of the financial statements is not material, the auditor should:

A. Refer to the change in an explanatory paragraph.
B. Explicitly concur that the change is preferred.
C. Not refer to consistency in the auditor's report.
D. Refer to the change in the opinion paragraph.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. If an accounting change has no material effect on the comparability of the financial statements, the auditor does not need to recognize the change in the current year's audit report. Choice "a" is incorrect. The change would only be referred to in an explanatory paragraph if the effect were material.
Choice "b" is incorrect. The auditor does not explicitly concur with the change in the report.
Choice "d" is incorrect. Even if the change had a material effect, the opinion paragraph would not be affected. The explanatory paragraph would follow the opinion paragraph.

QUESTION 39
When single-year financial statements are presented, an auditor ordinarily would express an unqualified opinion in an unmodified 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 unqualified opinion, is not presented.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Since only single-year financial statements are presented, the fact that another CPA audited the prior year's financial statements is not relevant. Therefore, the auditor would express an unqualified opinion in an unmodified report.
Choice "a" is incorrect. The situation described would result in a qualified opinion or disclaimer of opinion due to a scope limitation.
Choice "b" is incorrect. The situation described would result in an qualified opinion due to inadequate disclosure.
Choice "c" is incorrect. The situation described would result in an otherwise unqualified opinion modified by adding an additional explanatory paragraph after the opinion paragraph.

QUESTION 40
Park, CPA, was engaged to audit the financial statements of Tech Co., a new client, for the year ended December 31, 20X3. 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, 20X3, inventory balances. Park's opinion on Tech's 20X3 financial statements most likely will be:

Balance sheet	Income statement
A. Disclaimer	Disclaimer
B. Unqualified	Disclaimer
C. Disclaimer	Adverse
D. Unqualified	Adverse

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. When the auditor is unable to satisfy himself or herself regarding the amount of beginning inventory, he or she must disclaim an opinion on the income statement because of the inability to verify the cost of goods sold during the year. The auditor may, however, still be able to issue an unqualified opinion on the balance sheet, since inventory can be verified as of the balance sheet date. Choices "a", "c", and "d" are incorrect, based on the above.

QUESTION 41
Which paragraphs of an auditor's standard report on financial statements should refer to generally accepted auditing standards (GAAS) and generally accepted accounting principles (GAAP)?

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. The auditor states that the audit was conducted in accordance with GAAS in the scope paragraph. The auditor expresses an opinion on the financial statements' conformity with GAAP in the opinion paragraph. Choices "a", "b", and "d" are incorrect, per the above .

QUESTION 42
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 the FASB Statements 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.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. An adverse opinion is issued when the financial statements are not presented in accordance with GAAP.
Choice "a" is incorrect. The client's refusal to provide access to the minutes of the Board of Directors' meetings would result in a disclaimer of opinion.

Choice "b" is incorrect. If internal control is so poor that it cannot be relied upon, the auditor must consider the effect on the audit procedures and subsequent report, but would not issue an adverse opinion.
Choice "d" is incorrect. Substantial doubt with regard to the entity's ability to continue as a going concern should be disclosed in an additional explanatory paragraph appended to an otherwise unqualified opinion.

QUESTION 43
When disclaiming an opinion due to a client-imposed scope limitation, an auditor should indicate in a separate paragraph why the audit did not comply with generally accepted auditing standards. The auditor should also omit the:

	Scope paragraph	Opinion paragraph
A.	No	Yes
B.	Yes	Yes
C.	No	No
D.	Yes	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. When disclaiming an opinion because of scope limitations, the auditor should indicate in a separate paragraph(s) the reasons that the audit did not comply with GAAS. The auditor should also omit the scope paragraph. The opinion paragraph is not omitted; however it indicates that no opinion is expressed. Choices "a", "b", and "c" are incorrect, as per the above .

QUESTION 44
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.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. When an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself.
Choice "a" is incorrect. When an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself.
Choice "b" is incorrect. A scope limitation is a departure from generally accepted auditing standards.
However, when an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself.
Choice "d" is incorrect. Inadequate disclosure of necessary information is a departure from GAAP, rather than a scope limitation.

QUESTION 45
When an auditor qualifies an opinion because of inadequate disclosure, the auditor should describe the nature of the omission in a separate explanatory paragraph and modify the:

	Introductory paragraph	*Scope paragraph*
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A

B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. In a report qualified for inadequate disclosure, the auditor would add an explanatory paragraph and modify the opinion paragraph, but the introductory and scope paragraphs would not be modified. Choices "a", "b", and "c" are incorrect, as per the above .

QUESTION 46
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(an):

A. "Except for" qualified opinion.
B. Explanatory paragraph.
C. Unqualified opinion.
D. Consistency modification.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. If an accounting change has no material effect on the financial statements in the current year, but a material future effect, the auditor must ensure that the change is disclosed in the footnotes whenever the financial statements of the change period are presented, but does not have to recognize the change in the current year's audit report.
Choice "a" is incorrect. Accounting changes that are accounted for properly do not result in qualified opinions.
Choices "b" and "d" are incorrect. A consistency modification (explanatory paragraph) is not necessary when the effect of a change is immaterial.

QUESTION 47

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, the auditor ordinarily will express a(an):

A. Disclaimer of opinion.
B. Qualified opinion.
C. Review report.
D. Unqualified opinion with a separate explanatory paragraph.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. If a company issues financial statements that purport to present financial position and results of operations but omits the related statement of cash flows, the auditor will normally conclude that the omission requires qualification of the opinion.
Choice "a" is incorrect. If the company fails to present its statement of cash flows, this is considered inadequate disclosure. The auditor would not issue a disclaimer of opinion for inadequate disclosure. Choice "c" is incorrect. The auditor would not issue a review report when performing an audit.
Choice "d" is incorrect. The auditor cannot issue an unqualified report if the client omits a statement of cash flows from the financial statements.

QUESTION 48
In which of the following circumstances would an auditor most likely add an explanatory paragraph to the standard report while not affecting the auditor's unqualified opinion?

A. The auditor is asked to report on the balance sheet, but not on the other basic financial statements.
B. There is substantial doubt about the entity's ability to continue as a going concern.
C. Management's estimates of the effects of future events are unreasonable.
D. Certain transactions cannot be tested because of management's records retention policy.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph to reflect that

conclusion.
Choice "a" is incorrect. Reporting on just the balance sheet is acceptable provided access to financial information is not limited. Such reporting does not require an explanatory paragraph.
Choice "c" is incorrect. If the auditor concludes that management's estimate is unreasonable and that its effect is to cause the financial statements to be materially misstated, the auditor should express a qualified or an adverse opinion. Choice "d" is incorrect. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, may require the auditor to qualify or to disclaim an opinion.

QUESTION 49
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 explanatory 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.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The paragraph should refer to the note in the financial statements that discusses the change in detail. Following is an example of an appropriate explanatory paragraph: "As discussed in Note X to the financial statements, the company changed its method of accounting for income taxes in X2."
Choice "a" is incorrect. The auditor need not explain why a change from one generally accepted accounting principle to another is justified.
Choice "b" is incorrect. The paragraph should not identify the cumulative effect of the change on the audited financial statements.
Choice "c" is incorrect. The auditor should never explicitly state concurrence with a change. If the auditor opposes the change, a qualified or adverse opinion should be issued.

QUESTION 50
Green, CPA, was engaged to audit the financial statements of Essex Co. after its fiscal year had ended. The timing of Green's appointment as auditor and the start of fieldwork made confirmation of accounts receivable by direct communication with the debtors ineffective. However, Green applied other procedures and was satisfied as to the reasonableness of the account balances. Green's auditor's report most likely contained a(an):

A. Unqualified opinion.
B. Unqualified opinion with an explanatory paragraph.
C. Qualified opinion due to a scope limitation.
D. Qualified opinion due to a departure from generally accepted auditing standards.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. There is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless accounts receivable are immaterial, the use of confirmations would be ineffective, or the assessed inherent risk is so low that the evidence expected to be provided by analytical procedures or other substantive tests of details would be sufficient. In this example, the confirmation of accounts receivable by direct communication with the debtors would be ineffective. If Green was able to apply alternative audit procedures and was satisfied as to the reasonableness of the account balances, then an unqualified opinion could be issued.
Choice "b" is incorrect. Since Green was satisfied as far as the accounts receivable balances, there is no need to add an explanatory paragraph.
Choice "c" is incorrect. Since Green was able to perform alternative procedures and was satisfied as far as the reasonableness of the account balances, there is no scope limitation.
Choice "d" is incorrect. Since Green was able to perform alternative procedures and was satisfied as far as the reasonableness of the account balances, there is no departure from generally accepted auditing standards.

QUESTION 51
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.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Negotiating reductions in required dividends would conserve cash, which would be a mitigating factor in Davis' concerns about Hill's ability to continue as a going concern. Choice "a" is incorrect. Accelerating R&D projects would use cash and impair the company's ability to continue as a going concern.
Choice "b" is incorrect. Accumulating treasury stock would consume cash and aggravate the situation.

Choice "c" is incorrect. Purchasing equipment that is currently leased would use cash and impair the company further.

QUESTION 52
In the auditor's report, the principal auditor decides not to make reference to another CPA who audited a client's subsidiary. The principal auditor could justify this decision if, among other requirements, the principal auditor:

A. Issues an unqualified opinion on the consolidated financial statements.
B. Learns that the other CPA issued an unqualified opinion on the subsidiary's financial statements.
C. Is unable to review the audit programs and audit documentation of the other CPA.
D. Is satisfied as to the independence and professional reputation of the other CPA.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. If, among other requirements, the principal auditor is satisfied as to the independence and the professional reputation of the other auditor, the principal auditor may express an opinion on the financial statements taken as a whole without making reference to the audit of the other auditor.
Choice "a" is incorrect. Whether or not an unqualified opinion is issued is not the determining factor as to whether the principal auditor must make reference to another CPA.
Choice "b" is incorrect. Whether or not an unqualified opinion is issued on the subsidiary's financial statements is not the determining factor as to whether the principal auditor must make reference to another CPA.
Choice "c" is incorrect. If the principal auditor is unable to review the audit programs and audit documentation of the other CPA, he or she is likely to divide responsibility by making reference to the other CPA in the auditor's report.

QUESTION 53
A limitation on the scope of an audit sufficient to preclude an unqualified opinion will usually result when management:

A. Is unable to obtain audited financial statements supporting the entity's investment in a foreign subsidiary.
B. Refuses to disclose in the notes to the financial statements related party transactions authorized by the Board of Directors.
C. Does not provide the auditor with an engagement letter specifying the responsibilities of both the entity and the auditor.
D. Fails to correct a significant deficiency in internal control communicated to those charged with governance after the prior year's audit.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Restrictions on the scope of the audit, such as the timing of the work, the inability to obtain sufficient appropriate audit evidence, or an inadequacy in the accounting records, may require the auditor to qualify or disclaim an opinion. Inability to obtain audited financial statements supporting the entity's investment in a foreign subsidiary is such a restriction on the scope of the audit.
Choice "b" is incorrect. Client refusal to disclose related party transactions in the notes to the financial statements is a GAAP problem, not a scope problem. For a GAAP problem, the auditor must either issue a qualified or adverse opinion. Choice "c" is incorrect. The auditor sends an engagement letter to the client, not vice versa.
Choice "d" is incorrect. Management may choose not to correct a significant deficiency in internal control if the cost of correcting the condition outweighs the benefit.

QUESTION 54
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.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. Failure to disclose information that is required by GAAP is a departure from GAAP. Departures from GAAP result in a qualified or an adverse opinion.
Choice "a" is incorrect. If the auditor is unable to observe physical inventory and is unable to become satisfied through alternative means, that is a scope limitation. Scope limitations result in either a qualified opinion or a disclaimer of opinion.
Choice "c" is incorrect. The auditor can report on one financial statement and not the others. This does not preclude issuance of an unqualified opinion.
Choice "d" is incorrect. If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (after the opinion paragraph in the unqualified report) to reflect that conclusion.

QUESTION 55
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 unqualified opinion.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The opinion paragraph in an adverse opinion reads, "in our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements...." Choice "a" is incorrect. The principal effects of the departure from GAAP are included in the explanatory paragraph, not the opinion paragraph.
Choice "c" is incorrect. The "substantive reasons for the financial statements being misleading" are discussed in the explanatory paragraph, not the opinion paragraph. Choice "d" is incorrect. Scope limitations pertain to disclaimers of opinion, not adverse opinions.
(It is very important to memorize the qualifying phrases in the qualified, adverse, and disclaimer of opinions.)

QUESTION 56
Under which of the following circumstances would a disclaimer of opinion not be appropriate?

A. The financial statements fail to contain adequate disclosure of related party transactions.
B. The client refuses to permit its attorney to furnish information requested in a letter of audit inquiry.
C. The auditor is engaged after fiscal year-end and is unable to observe physical inventories or apply alternative procedures to verify their balances.
D. The auditor is unable to determine the amounts associated with illegal acts committed by the client's management.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The failure of the financial statements to contain adequate disclosure of related party transactions, or other required disclosures, would result in a qualified or adverse opinion, not a disclaimer of opinion. Choice "b" is incorrect. A client's refusal to permit its attorney to furnish information requested in a letter of audit inquiry would generally result in a disclaimer of opinion.
Choice "c" is incorrect. The auditor's inability to observe physical inventories or apply alternative procedures to verify their balances could result in a disclaimer.

Choice "d" is incorrect. The auditor's inability to determine the amounts associated with illegal acts committed by the client's management could result in a disclaimer.

QUESTION 57
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 explanatory 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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. "Yes - Yes - Yes."
When a CPA concludes that there is substantial doubt about an entity's ability to continue as a going concern and the entity adequately discloses its financial

difficulties, an unqualified opinion is appropriate. An explanatory paragraph (following the opinion paragraph) should be used to highlight the situation. This paragraph should include the phrases "substantial doubt" and "going concern." Choices "b", "c", and "d" are incorrect, per above.

QUESTION 58
An auditor may reasonably issue an "except for" qualified opinion for a(an):

	Scope limitation	Unjustified accounting change
A.	Yes	No
B.	No	Yes
C.	Yes	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. Yes - Yes.
An "except for" qualified opinion is expressed when the "exceptions to GAAP" are not material enough to warrant an adverse opinion, or when scope restrictions are not material enough to warrant a disclaimer. Choices "a", "b", and "d" are incorrect, per rule above.

QUESTION 59
The following explanatory paragraph was included in an auditor's report to indicate a lack of consistency:
"As discussed in note T to the financial statements, the company changed its method of computing depreciation in X0."
How should the auditor report on this matter if the auditor concurred with the change? Type of Location of opinion explanatory paragraph

A. Unqualified Before opinion paragraph

B. Unqualified After opinion paragraph
C. Qualified Before opinion paragraph
D. Qualified After opinion paragraph

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. If the auditor concurred with the change, a lack of consistency in applying GAAP would result in an unqualified opinion with an explanatory paragraph following the opinion paragraph.
Choice "c" is incorrect. If the change in accounting principle is not accounted for properly, then a qualified opinion would be appropriate and the explanatory paragraph would appear before the opinion paragraph. Choices "a" and "d" are incorrect, per the above rules.

QUESTION 60
How does an auditor make the following representations when issuing the standard auditor's report on comparative financial statements?

	Type of opinion	Location of explanatory paragraph
A.	Unqualified	Before opinion paragraph
B.	Unqualified	After opinion paragraph
C.	Qualified	Before opinion paragraph
D.	Qualified	After opinion paragraph

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Explicitly - Implicitly.
The auditor explicitly states in the scope paragraph of his opinion: "an audit includes examining, on a test basis, evidence supporting..."
Consistency is implied in the auditor's standard report.
Choices "a", "b", and "c" are incorrect, as per above .

QUESTION 61
An auditor was unable to obtain sufficient appropriate audit evidence concerning certain transactions due to an inadequacy in the entity's accounting records. The auditor would choose between issuing a(an):

A. Qualified opinion and an unqualified opinion with an explanatory paragraph.
B. Unqualified opinion with an explanatory paragraph and an adverse opinion.
C. Adverse opinion and a disclaimer of opinion.
D. Disclaimer of opinion and a qualified opinion.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Client-imposed restrictions of scope such as those caused by inadequate records would cause the auditor to choose between issuing a disclaimer of opinion and a qualified opinion. Choice "a" is incorrect. An unqualified opinion would only be justified if the transactions in question-were not material, but in such situations, no explanatory paragraph would be required. Choices "b" and "c" are incorrect. An adverse opinion pertains to GAAP and would not be used for reporting restrictions of scope.

QUESTION 62
In which of the following situations would a principal auditor least likely make reference to another auditor who audited a subsidiary of the entity?

A. The other auditor was retained by the principal auditor and the work was performed under the principal auditor's guidance and control.
B. The principal auditor finds it impracticable to review the other auditor's work or otherwise be satisfied as to the other auditor's work.
C. The financial statements audited by the other auditor are material to the consolidated financial statements covered by the principal auditor's opinion.
D. The principal auditor is unable to be satisfied as to the independence and professional reputation of the other auditor.

Correct Answer: A
Section: Volume A

Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. When the principal auditor assumes responsibility for the other auditor's work, the principal auditor would not mention the other auditor in his audit report (opinion). The principal auditor would generally assume responsibility after reviewing the audit documentation of the other auditor and performing supplemental audit tests, or by reputation, e.g., if the other auditor is a correspondent (foreign) firm in which the principal auditor has developed confidence.
Choices "b" and "c" are incorrect. When the principal auditor finds it impractical to review the other auditor's work, or when the FS audited by the other auditor are material, it is more likely that the principal auditor will divide responsibility and make reference to the other auditor.
Choice "d" is incorrect. The principal auditor should always make inquiries regarding the independence and professional reputation of the other auditor. Inability to become satisfied in this regard would constitute a scope limitation, resulting in a qualified opinion or disclaimer of opinion. In either of these scenarios, it is likely that the other auditor would be mentioned within an explanatory paragraph.

QUESTION 63
In which of the following situations would an auditor ordinarily issue an unqualified audit opinion without an explanatory 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 another auditor as a basis, in part, for the auditor's opinion.
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.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. An auditor would generally issue an unqualified audit opinion without an explanatory paragraph when the auditor decides to make reference to the report of another auditor as a basis, in part, for the auditor's opinion.
The auditor would modify his/her report (all three paragraphs), but would not add an explanatory paragraph.
Choices "a" and "d" are incorrect. An auditor ordinarily would issue an unqualified opinion with an explanatory paragraph if he or she wishes to emphasize that the entity had significant related party transactions, or if the auditor has substantial doubt about the entity's ability to continue as a going concern (even if the circumstances are fully disclosed in the financial statements).
Choice "c" is incorrect. If the entity issues financial statements that present financial position and results of operations but omit the statement of cash flows, the opinion will be qualified.

QUESTION 64
When there has been a change in accounting principle that materially affects the comparability of the comparative financial statements presented and the auditor concurs with the change, the auditor should:

	Concur explicitly with the change	Issue an "except for" qualified opinion	Refer to the change in an explanatory paragraph
A.	No	No	Yes
B.	Yes	No	Yes
C.	Yes	Yes	No
D.	No	Yes	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. No - No - Yes.
When a change in accounting principle materially affects the comparability of the comparative FS, the auditor should refer to the change in an explanatory paragraph following the unqualified opinion paragraph. Choices "b" and "c" are incorrect. The auditor's concurrence with a change in GAAP is implicit, not explicit. Choice "d" is incorrect. An unqualified opinion should be issued, not an "except for" qualified opinion.

QUESTION 65
When a qualified opinion results from a limitation on the scope of the audit, the situation should be described in an explanatory paragraph:

A. Preceding the opinion paragraph and referred to only in the scope paragraph of the auditor's report.

B. Following the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report.
C. Following the opinion paragraph and referred to only in the scope paragraph of the auditor's report.
D. Preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. When a qualified opinion results from a limitation of scope, it should be described in an explanatory paragraph preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report.
Choices "a", "b", and "c" are incorrect, as they do not comply with the rule above.

QUESTION 66
Restrictions imposed by a client prohibit the observation of physical inventories, which account for 35% of all assets. Alternative audit procedures cannot be applied, although the auditor was able to examine satisfactory evidence for all other items in the financial statements. The auditor should issue a(an):

A. "Except for" qualified opinion.
B. Disclaimer of opinion.
C. Unqualified opinion with a separate explanatory paragraph.
D. Unqualified opinion with an in the scope paragraph.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. Restrictions of scope imposed on the audit of such a large (35%) asset would require a disclaimer of opinion.
Choices "a" and "c" are incorrect. The asset not audited is too large for a qualified opinion and much too large for an unqualified opinion. Choice "d" is incorrect. Explanatory language does not get inserted into the scope paragraph, nor is an unqualified opinion appropriate.

QUESTION 67
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 disclosures concerning this matter are adequate, the audit report may include a(an):

	Disclaimer of opinion	"Except for" qualified opinion
A.	Yes	Yes
B.	No	No
C.	No	Yes
D.	Yes	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Yes - No.
If an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern and that the entity's disclosures are adequate, then the audit report may be either: - Unqualified with explanatory paragraph, or - Disclaimed.
(Generally, an unqualified opinion is issued, but the auditor is not prohibited from choosing to issue a disclaimer.)
Choice "a" is incorrect. An "except for" qualified opinion would be appropriate if the entity's disclosures were inadequate.
Choice "b" is incorrect. While an unqualified opinion is generally issued, the auditor is not prohibited from choosing to issue a disclaimer; for example, in areas involving a high degree of uncertainty. Choice "c" is incorrect, per above.

QUESTION 68
An auditor should disclose the substantive reasons for expressing an adverse opinion in an explanatory paragraph:

A. Preceding the scope paragraph.
B. Preceding the opinion paragraph.
C. Following the opinion paragraph.
D. Within the notes to the financial statements.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The auditor should disclose the substantive reasons for expressing an adverse opinion in a separate explanatory paragraph preceding the opinion paragraph.
Choice "a" is incorrect. There are no circumstances where an explanatory paragraph precedes the scope paragraph.
Choice "c" is incorrect. The explanatory paragraph follows the opinion paragraph when there is a change in accounting principle or when there is doubt as to going concern. Choice "d" is incorrect. The auditor cannot include an explanatory paragraph in the financial statements, which are the responsibility of management.

QUESTION 69
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.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. When management does not provide reasonable justification that a change in accounting principle is preferable and it presents comparative FS, the auditor should express a qualified opinion each year that the FS initially reflecting the change are presented.
Choices "a", "c", and "d" are incorrect, per the rule stated above.

QUESTION 70
When an independent CPA is associated with the financial statements of a publicly held entity but has not audited or reviewed such statements, the appropriate form of report to be issued must include a(an):

A. Compilation report.

B. Disclaimer of opinion.
C. Unaudited association report.
D. Qualified opinion.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. A "disclaimer of opinion" must be issued when a CPA is "associated" with FS of a publicly held entity, but has not audited or (interim) reviewed such FS. Choice "a" is incorrect. A "compilation report" refers to a report related to a non-public entity.
Choice "c" is incorrect. There is no such thing as an "unaudited association report."
Choice "d" is incorrect. The auditor did not audit the FS, so he/she cannot issue an opinion on them.

QUESTION 71
Restrictions imposed by a retail entity that is a new client prevent an auditor from observing any physical inventories. These inventories account for 40% of the entity's assets. Alternative auditing procedures cannot be applied due to the nature of the entity's records. Under these circumstances, the auditor should express a(an):

A. Disclaimer of opinion.
B. Qualified opinion.
C. Adverse opinion.
D. Unqualified opinion with an explanatory paragraph.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Since the auditor is unable to observe inventory or apply alternative audit procedures, a scope limitation exists. Due to the significance of the inventory balance (40% of total assets is quite material), a disclaimer of opinion (rather than simply a qualification) is appropriate.
Choice "b" is incorrect. Since the inventory balance is so material, a qualified opinion is not sufficient in this case.
Choice "c" is incorrect. An adverse opinion is not an appropriate response to a scope limitation.
Choice "d" is incorrect. Since the scope limitation relates to a material balance, an unqualified opinion is not appropriate.

QUESTION 72
Which of the following audit 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. Reading the minutes of meetings of the stockholders and the board of directors.
B. Comparing the market value of property to amounts owed on the property.
C. Reviewing lease agreements to determine whether leased assets should be capitalized.
D. Inspecting title documents to verify whether any assets are pledged as collateral.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The auditor should examine any evidence that appears contrary to the basic principle of going concern. Reviewing the minutes from stockholder and board of director meetings is one procedure that is used in this regard.
Choice "b" is incorrect. Comparison of the market value of property to amounts owed on the property determines its net value, but would not necessarily indicate a going concern issue.
Choice "c" is incorrect. Reviewing lease agreements to determine whether leased assets should be capitalized is important in evaluating the financial statements, but it would not provide evidence of going concern issues.
Choice "d" is incorrect. Inspecting title documents to verify whether any assets are pledged as collateral provides information regarding presentation and disclosure, but would not provide evidence of going concern issues.

QUESTION 73
Which of the following 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. Performing cutoff tests of sales transactions with customers with long-standing receivable balances.
B. Evaluating the entity's procedures for identifying and recording related party transactions.
C. Inspecting title documents to verify whether any real property is pledged as collateral.
D. Inquiring of the entity's legal counsel about litigation, claims, and assessments.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. If a liability is significant enough, it may give rise to a situation in which there is substantial doubt about an entity's ability to continue as a going concern. Inquiring of an entity's legal counsel about litigation, claims, and assessments is one way to determine whether such a liability exists.
Choice "a" is incorrect. Cutoff tests are used to determine whether sales are recorded in the proper period. Applying such tests to customer accounts with long-standing receivable balances would not provide information about the entity's ability to continue a as a going concern.
Choice "b" is incorrect. Evaluating the entity's procedures for identifying and recording related party transactions is a means for the auditor to evaluate financial statement presentation and disclosure, but it does not provide information about going concern issues.
Choice "c" is incorrect. Identifying situations in which real property is pledged as collateral is a means for the auditor to evaluate financial statement presentation and disclosure, but it does not provide information about going concern issues.

QUESTION 74
A CPA's standard report on audited financial statements would be inappropriate if it referred to:

A. Management's responsibility for the financial statements.
B. An assessment of the entity's accounting principles.
C. Significant estimates made by management.
D. The CPA's assessment of sampling risk factors.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The CPA's standard report on audited financial statements does not include matters related to the auditor's assessment of specific risk factors.
Choice "a" is incorrect. The CPA's standard report on audited financial statements states that, "These financial statements are the responsibility of the Company's management."
Choices "b" and "c" are incorrect. The CPA's standard report on audited financial statements states that, "An audit also includes assessing the accounting principles used and significant estimates made by management."

QUESTION 75
When an auditor has substantial doubt about an entity's ability to continue as a going concern because of the probable discontinuance of operations, the auditor most likely would express a qualified opinion if:

A. The effects of the adverse financial conditions likely will cause a bankruptcy filing.

B. Information about the entity's ability to continue as a going concern is not disclosed.
C. Management has no plans to reduce or delay future expenditures.
D. Negative trends and recurring operating losses appear to be irreversible.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. In a situation where it is likely that an entity's operations will be discontinued, disclosure of information about the entity's ability to continue as a going concern is required by GAAP.
Failure to make such disclosure would be a departure from GAAP, resulting in either a qualified or adverse opinion.
Choice "a" is incorrect. As long as the going concern situation is adequately disclosed, the fact that there will be a bankruptcy filing would not cause the auditor to express a qualified opinion. Generally, an explanatory paragraph would be added following the opinion paragraph of the unqualified report.
Choice "c" is incorrect. As long as the going concern situation is adequately disclosed, the fact that management does not intend to reduce or delay future expenditures would not cause the auditor to express a qualified opinion. Generally, an explanatory paragraph would be added following the opinion paragraph of the unqualified report.
Choice "d" is incorrect. As long as the going concern situation is adequately disclosed, the fact that negative trends and recurring operating loses appear to be irreversible would not cause the auditor to express a qualified opinion. Generally, an explanatory paragraph would be added following the opinion paragraph of the unqualified report.

QUESTION 76
An auditor believes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. In evaluating the entity's plans for dealing with the adverse effects of future conditions and events, the auditor most likely would consider, as a mitigating factor, the entity's plans to:

A. Repurchase the entity's stock at a price below its book value.
B. Issue stock options to key executives.
C. Lease rather than purchase operating facilities.
D. Accelerate the due date of an existing mortgage.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. Leasing rather than purchasing operating facilities results in reduced (or at least delayed) expenditures, which is a mitigating factor in a going concern situation.
Choice "a" is incorrect. Mitigating factors in a going concern situation include plans to dispose of assets, plans to borrow money or restructure debt, plans to reduce or delay expenditures, or plans to increase ownership equity. Repurchasing stock is an outflow of cash that would reduce ownership equity; as such, it is not a mitigating factor.
Choice "b" is incorrect. Mitigating factors in a going concern situation include plans to dispose of assets, plans to borrow money or restructure debt, plans to reduce or delay expenditures, or plans to increase ownership equity. Issuing stock options does not fall into any of these categories and would not be considered a mitigating factor.
Choice "d" is incorrect. Mitigating factors in a going concern situation include plans to dispose of assets, plans to borrow money or restructure debt, plans to reduce or delay expenditures, or plans to increase ownership equity. Accelerating the due date of an existing mortgage would increase expenditures, and therefore would not be a mitigating factor.

QUESTION 77
Which of the following is true regarding the standard audit report for an issuer?

A. Reference should be made in the scope paragraph to both PCAOB standards and generally accepted auditing standards.
B. PCAOB standards should not be mentioned at all, although their use is implied in the standard auditor's report.
C. Reference should be made in the scope paragraph to PCAOB standards, and in the opinion paragraph to generally accepted accounting principles.
D. Reference may be made in the scope paragraph to either PCAOB standards or generally accepted auditing standards.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. An auditor reporting on the audit of financial statements of an issuer should indicate in the scope paragraph that the engagement was conducted in accordance with PCAOB standards, and should refer to GAAP in the opinion paragraph.
Choice "a" is incorrect. An auditor reporting on the audit of financial statements of a nonissuer may (but is not required to) refer to both PCAOB standards and generally accepted auditing standards in the scope paragraph. Audit reports for audits of issuers refer only to PCAOB standards in the scope paragraph.
Choice "b" is incorrect. An auditor reporting on the audit of financial statements of an issuer should indicate in the scope paragraph that the engagement was conducted in accordance with PCAOB standards. This is an explicit statement in the report; it is not implied or assumed.
Choice "d" is incorrect. An auditor reporting on the audit of financial statements of an issuer should indicate in the scope paragraph that the engagement was conducted in accordance with PCAOB standards. Referring to generally accepted auditing standards instead is not an option, as audits of issuers must follow PCAOB standards.

QUESTION 78
Under which of the following circumstances would an auditor's expression of an unqualified opinion be inappropriate?

A. The auditor is unable to obtain the audited financial statements of a significant subsidiary.
B. The financial statements are prepared on the entity's income tax basis.
C. There are significant deficiencies in the design and operation of the entity's internal control.
D. Analytical procedures indicate that many year-end account balances are not comparable with the prior year's balances.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. If the auditor is unable to obtain the audited financial statements of a significant subsidiary, a scope limitation exists. Assuming the effect is material, the auditor would issue either a qualified opinion or a disclaimer of opinion.
Choice "b" is incorrect. Financial statements prepared on an entity's income tax basis are "other comprehensive basis of accounting" (OCBOA) financial statements. The auditor may issue a special report, which can include an unqualified opinion, on OCBOA financial statements.
Choice "c" is incorrect. Significant deficiencies in the design and operation of an entity's internal control do not preclude issuance of an unqualified opinion, although they do increase the risk of material misstatement and will likely result in modifications to the nature, timing, and extent of the auditor's testing.
Choice "d" is incorrect. An unqualified opinion may still be expressed when there are significant changes in year-end account balances as compared to prior year balances, as long as the auditor has obtained sufficient appropriate audit evidence about the current balances.
Reports on Comparative Financial Statements

QUESTION 79
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.

Correct Answer: D

Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the introductory paragraph of the report 1) that the financial statements of the prior period were audited by another auditor, 2) the date of his report, 3) the type of report issued by the predecessor auditor, and 4) if the report was other than a standard unqualified report, the substantive reasons therefor. The successor auditor may name the predecessor auditor only if the predecessor auditor's practice was acquired by or merged with that of the successor auditor. Choices "a", "b", and "c" are incorrect, based on the above .

QUESTION 80
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.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Before reissuing the prior year's audit report on the financial statements of a former client, the auditor should 1) read the financial statements of the current period, 2) compare the prior period information that the auditor reported on with the financial statements to be presented for comparative purposes, and 3) obtain letters of representation from management of the former client and from the successor auditor. The representation letter from management should indicate whether any of management's previous representations should be modified and whether there have been any subsequent events that would affect the previous financial statements. The representation letter from the successor auditor should state whether the successor auditor's audit disclosed any issues of a material nature that might affect the previous financial statements.
Choice "b" is incorrect. The predecessor auditor is seeking independent confirmation regarding issues that might materially affect the previous financial statements. A representation letter from the client's audit committee would not provide this confirmation.
Choice "c" is incorrect. The predecessor auditor is seeking independent confirmation regarding issues that might materially affect the previous financial statements. A representation letter from the principal underwriter would not provide this confirmation.
Choice "d" is incorrect. The predecessor auditor is seeking independent confirmation regarding issues that might materially affect the previous financial

statements. A representation letter from the SEC would not provide this confirmation.

QUESTION 81
Before reissuing the prior year's auditor's report on the financial statements of a former client, the predecessor auditor should obtain letters of representation from the:

A. Former client's management and the board of directors.
B. Former client's attorney and management.
C. Former client's board of directors and the successor auditor.
D. Successor auditor and the former client's management.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Before reissuing the prior year's auditor's report on the financial statements of a former client, the auditor should 1) read the financial statements of the current period, 2) compare the prior-period information that the auditor reported on with the financial statements to be presented for comparative purposes, 3) obtain a letter of representation from the successor auditor, and 4) obtain a letter of representation from the former client's management. The representation letter from the successor auditor will state whether the successor's audit revealed any issues of a material nature that might affect the previous financial statements. The representation letter from the former client's management will indicate whether its previous representations are still accurate and whether there have been any subsequent events affecting the previous financial statements. Choices "a", "b", and "c" are incorrect. The predecessor does not request representation letters from the former client's board of directors or attorney.

QUESTION 82
In May X4, an auditor reissues the auditor's report on the X2 financial statements at a continuing client's request. The X2 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.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. If the auditor reissues the audit report at the client's request, the auditor should use the original report date on the reissued report. Use of a subsequent date implies that the auditor has done additional work. Choice "a" is incorrect. Use of a date subsequent to the original report date implies that the auditor has performed work subsequent to that date.
Choice "b" is incorrect. Use of a date subsequent to the original report date implies that the auditor has performed work subsequent to that date. Choice "d" is incorrect. Use of a date subsequent to the original report date implies that the auditor has performed work subsequent to that date.

QUESTION 83
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 unqualified opinion on the restated financial statements of the prior year.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. If an auditor has previously qualified his or her opinion on financial statements of a prior period, and the prior period statements are restated to conform with GAAP, the auditor should express an unqualified opinion on the restated financial statements. In addition, the auditor would state the substantive reasons for the change in opinion in an explanatory paragraph preceding the opinion paragraph. Choice "a" is incorrect. The original report would not be presented.
Choice "b" is incorrect. The auditor would change the opinion on the restated financial statements from that previously issued.
Choice "c" is incorrect. The auditor would state the substantive reasons for the change in opinion in an explanatory paragraph preceding the opinion paragraph.

QUESTION 84
Comparative financial statements include the financial statements of the prior year that were audited by a predecessor auditor whose report is not presented. If the predecessor's report was qualified, the successor should:

A. Indicate the substantive reasons for the qualification in the predecessor auditor's opinion.

B. Request the client to reissue the predecessor's report on the prior year's statements.
C. Issue an updated comparative audit report indicating the division of responsibility.
D. Express an opinion only on the current year's statements and make no reference to the prior year's statements.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the introductory paragraph of the audit report (1) that the financial statements of the prior period were audited by another auditor, (2) the type of report issued, and (3) if the report was other than standard, the substantive reasons therefor.
Choice "b" is incorrect. The predecessor auditor, not the client, may reissue the previous year's audit report.
Choice "c" is incorrect. An audit report would indicate a division of responsibility when the principal auditor's opinion is based in part on the report of another auditor. Choice "d" is incorrect. If the prior year's financial statements are issued, the previous year's audit opinion must also be disclosed.

QUESTION 85
An auditor has previously expressed a qualified opinion on the financial statements of a prior period because of a departure from generally accepted accounting principles. The prior-period financial statements are restated in the current period to conform with generally accepted accounting principles.
The auditor's updated report on the prior-period financial statements should:

A. Express an unqualified opinion concerning the restated financial statements.
B. Be accompanied by the original auditor's report on the prior period.
C. Bear the same date as the original auditor's report on the prior period.
D. Qualify the opinion concerning the restated financial statements because of a change in accounting principle.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. When prior-period financial statements are restated in the current period to conform with GAAP, the auditor's updated report on the prior-period financial statements should express an unqualified opinion concerning the restated financial statements.

Choice "b" is incorrect. The original auditor's report on the prior period should not be presented.
Choice "c" is incorrect. The original report date is used only if the original report is reissued unchanged.
Choice "d" is incorrect. A change in accounting principle that is properly accounted for does not result in a qualified opinion.
Events Occurring After Year-end

QUESTION 86
Which of the following statements is not true regarding the auditor's responsibility for subsequent events?

A. The auditor has an active responsibility to make continuing inquiries between the date of the auditor's report and the date on which the report is submitted.
B. The auditor has an active responsibility to make continuing inquiries between the date of the financial statements and the date of the auditor's report.
C. The auditor has an active responsibility to make continuing inquiries between the date of the financial statements and the date on which sufficient appropriate audit evidence has been obtained.
D. The auditor has no active responsibility to make continuing inquiries after the date of the auditor's report.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The auditor has no active responsibility to make continuing inquiries between the date of the auditor's report and the date on which the report is submitted. The auditor's active responsibility stops on the date of the auditor's report.
Choice "b" is incorrect. The auditor does have an active responsibility to make continuing inquiries between the date of the financial statements and the date of the auditor's report.
Choice "c" is incorrect. The auditor does have an active responsibility to make continuing inquiries between the date of the financial statements and the date on which sufficient appropriate audit evidence has been obtained. Choice "d" is incorrect. The auditor has no active responsibility to make continuing inquiries after the date of the auditor's report.

QUESTION 87
Which of the following procedures would an auditor most likely perform to obtain evidence about the occurrence of subsequent events?

A. Confirming a sample of material accounts receivable established after year-end.
B. Comparing the financial statements being reported on with those of the prior period.
C. Investigating personnel changes in the accounting department occurring after year-end.
D. Inquiring as to whether any unusual adjustments were made after year-end.

Correct Answer: D

Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. An auditor would most likely inquire as to whether any unusual adjustments were made after year-end that would require adjustment to and/or disclosure in the year-end financial statements.
Choice "a" is incorrect. Obtaining evidence about A/R that were established after year-end would not provide the auditor with information about subsequent events, since any information about these A/R would not require adjustment to or disclosure in the prior year financial statements.
Choice "b" is incorrect. Comparing the financial statements being reported on with those of the prior period is not a very good source of subsequent event information. Choice "c" is incorrect. Changes in accounting personnel at any time would probably not result in any subsequent event financial statement adjustment or disclosure.

QUESTION 88
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.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. The question-addresses the subsequent discovery of facts that may have existed at the balance sheet date. Such events will often require an adjustment to the financial statements. An example is new information discovered about undisclosed lease transactions of the audited period. As a result, the auditor should make further inquiry to determine whether the information is reliable and whether the facts existed at the date of the report.
Choice "a" is incorrect. The natural disaster is an example of a subsequent event occurring after the date of the auditor's report that the auditor has no obligation to investigate.
Choice "b" is incorrect. The resolution of a disclosed contingency is an example of a subsequent event occurring after the date of the auditor's report that the auditor has no obligation to investigate. Choice "d" is incorrect. Sale of a subsidiary occurring after the date of the auditor's report is an example of a subsequent event that the auditor has no obligation to investigate.

QUESTION 89
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.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. In obtaining evidence about subsequent events, an auditor would investigate changes in long-term debt occurring after year-end to determine if there was an unrecorded liability as of the end of the year. In addition, subsequent sales of LT debt require footnote disclosure.
Choice "a" is incorrect. Changes in employee pay rates occurring after year-end would have no effect on the year under audit.
Choice "b" is incorrect. Plant assets sold after the end of the year (that were not related to a current year transaction such as a discontinued operation) have no impact on the current year's financial statements.
Choice "c" is incorrect.
Following up on payroll checks that were cashed after year-end is generally not the most effective way to audit accrued payroll and would provide little evidence about subsequent events.

QUESTION 90
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:

A. Financial statements and auditor's report were not distributed beyond management and the board of directors.
B. Auditor's previously expressed opinion was qualified because of a departure from GAAP.
C. Results of other procedures that were applied tend to compensate for the procedure omitted.
D. Omission is due to unreasonable delays by client personnel in providing data on a timely basis.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. When the auditor concludes that an auditing procedure considered necessary at the time of the audit was omitted, the auditor should assess the importance of the procedure to the present ability to support the previously issued opinion. The results of other procedures that were applied may tend to compensate for the one omitted or make its omission less important.
Choice "a" is incorrect. If a procedure has been omitted, the auditor must consider whether other parties may be relying on the financial statements, even if the audit report had limited distribution. Choice "b" is incorrect. The fact that the previous opinion was qualified does not negate the need to apply the omitted procedure. Choice "d" is incorrect. Delays by client personnel may extend audit work, but do not provide a reason for omitting a procedure.

QUESTION 91
Subsequent to the issuance of an auditor's report, the auditor became aware of facts existing at the report date that would have affected the report had the auditor then been aware of such facts. After determining that the information is reliable, the auditor should next:

A. Determine whether there are persons relying or likely to rely on the financial statements who would attach importance to the information.
B. Request that management disclose the newly discovered information by issuing revised financial statements.
C. Issue revised pro forma financial statements taking into consideration the newly discovered information.
D. Give public notice that the auditor is no longer associated with financial statements.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. When subsequently discovered information is found both to be reliable and to have existed at the date of the auditor's report, the auditor should determine whether there are persons relying or likely to rely on the financial statements who would attach importance to the information.
Choice "b" is incorrect. The auditor would request that management disclose the newly discovered information only after determining whether there are persons relying on the information.
Choice "c" is incorrect. Management, not the auditor, may issue revised financial statements.
Choice "d" is incorrect. The auditor would give public notice that he/she is no longer associated with the FS only after determining that there are persons relying on the information and only if the client refuses to issue revised FS.

QUESTION 92
On March 15, X4, Kent, CPA, issued an unqualified opinion on a client's audited financial statements for the year ended December 31, X3. On May 4, X4, 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:

A. Advise management to disclose to the stockholders that Kent's unqualified opinion should not be relied on.

B. Undertake to apply alternative procedures that would provide a satisfactory basis for the unqualified opinion.
C. 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.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. In the event of omitted audit procedures, the auditor should first attempt to perform alternative procedures in order to ascertain whether the original opinion can be relied upon.
Choice "a" is incorrect. The auditor would only advise the client to notify all stockholders and other financial statement users that the unqualified opinion cannot be relied upon if the auditor cannot satisfy himself (with alternative procedures) as to the propriety of the original opinion.
Choice "c" is incorrect. The auditor may need to reissue the audit report if the auditor is unable to satisfy himself using alternative procedures; the opinion issued should be qualified or disclaimed, due to the scope limitation. Choice "d" is incorrect. Tests of controls are not appropriate alternative procedures.

QUESTION 93
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. A technological development that could affect the entity's future ability to continue as a going concern.
B. The discovery of information regarding a contingency that existed before the financial statements were issued.
C. The entity's sale of a subsidiary that accounts for 30% of the entity's consolidated sales.
D. The final resolution of a lawsuit explained in a separate paragraph of the auditor's report.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. With respect to events occurring after the issuance of an auditor's report, the auditor is only responsible for information that existed at the audit report date.
Choice "a" is incorrect. Since the information did not exist at the report date, the auditor has no obligation to make any further inquiry. Choice "c" is incorrect. Since the information did not exist at the report date, the auditor has no obligation to make any further inquiry.

Choice "d" is incorrect. Since the information did not exist at the report date, the auditor has no obligation to make any further inquiry.

QUESTION 94
Wilson, CPA, obtained sufficient appropriate audit evidence to render an opinion on Abco's December 31, X1, financial statements on March 6, X2. A subsequent event requiring adjustment to the X1 financial statements occurred on April 10, X2, and came to Wilson's attention on April 24, X2. If the adjustment is made without disclosure of the event, Wilson's report ordinarily should be dated:

A. March 6, X2.
B. April 10, X2.
C. April 24, X2.
D. Using dual dating.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Since the financial statements were adjusted without disclosure of the event in the footnotes, Wilson's report should be dated as of March 6, X2, the date on which sufficient appropriate audit evidence was obtained.
Choice "b" is incorrect. An April 10, X2 report date would be used only if the event were disclosed and Wilson wanted to extend the responsibility for all significant events through April 10, X2. Choice "c" is incorrect. An April 24, X2 report date would be used only if the event were disclosed and Wilson wanted to extend the responsibility for all significant events through April 24, X2. Choice "d" is incorrect. Dual dating would only be used if the event were disclosed in the notes to the financial statements.

QUESTION 95
An auditor concludes that a substantive auditing procedure considered necessary during the prior period's audit was omitted. Which of the following factors would most likely cause the auditor promptly to apply the omitted procedure?

A. There are no alternative procedures available to provide the same evidence as the omitted procedure.
B. The omission of the procedure impairs the auditor's present ability to support the previously expressed opinion.
C. The source documents needed to perform the omitted procedure are still available.
D. The auditor's opinion on the prior period's financial statements was unqualified.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The factor most likely to cause the auditor to promptly apply the omitted procedure would be if the omission impairs the auditor's present ability to support the previously expressed opinion.
Choice "a" is incorrect. The auditor would first need to determine whether the omission of the procedure impairs the ability to support the previously expressed opinion. It is possible that other procedures already performed tended to compensate for the omitted procedure, and therefore no further action would be necessary.
Choice "c" is incorrect. The availability of the source documents needed to perform the procedure has little bearing on whether the auditor determines that it is necessary to perform the procedure. Choice "d" is incorrect. The rendering of a clean opinion has little importance. The issue is "support of the previously expressed opinion," not what the opinion was.

QUESTION 96
After issuing a report, an auditor has no obligation to make continuing inquiries or perform other procedures concerning the audited financial statements, unless:

A. Information, which existed at the report date and may affect the report, comes to the auditor's attention.
B. Management of the entity requests the auditor to reissue the auditor's report.
C. Information about an event that occurred after the date of the auditor's report comes to the auditor's attention.
D. Final determinations or resolutions are made of contingencies that had been disclosed in the financial statements.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. After issuing a report, an auditor has no obligation to make continuing inquiries or perform other procedures concerning the audited financial statements, unless information, which existed at the report date and may affect the report, comes to the auditor's attention. In this case the auditor would perform procedures to determine if the information affects the report and is important to the external users.
Choice "b" is incorrect. The auditor has no obligation to perform other procedures if management of the entity requests the auditor to reissue the auditor's report (if no significant changes have occurred since the report date).
Choice "c" is incorrect. The auditor has no obligation to perform other procedures if information about an event that occurred after the date of the auditor's report comes to the auditor's attention (and the auditor has not been asked to reissue the report).
Choice "d" is incorrect. Most contingencies are eventually resolved; however, such resolution does not require the auditor to perform other procedures.

QUESTION 97
Which of the following procedures would an auditor most likely perform in obtaining evidence about subsequent events?

A. Examine a sample of transactions that occurred since the year-end to verify the effectiveness of computer controls.
B. Inquire of management whether there have been significant changes in working capital since the year-end.
C. Recompute depreciation charges for plant assets sold for substantial gains since the year-end.
D. Reperform the tests of controls that indicated significant deficiencies in the operation of internal control.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. In obtaining evidence about subsequent events, the auditor would most likely inquire of management whether there have been significant changes in working capital since year-end.
Such changes could be indicative of a going concern problem, which would require financial statement disclosure.
Choice "a" is incorrect. Subsequent events are material events or transactions occurring subsequent to the balance sheet date, but prior to the issuance of the financial statements, that require adjustment to or disclosure in the financial statements. Reviewing a sample of transactions occurring after year-end to verify the effectiveness of computer controls would not be likely to provide information about subsequent events.
Choice "c" is incorrect. Subsequent events are material events or transactions occurring subsequent to the balance sheet date, but prior to the issuance of the financial statements, that require adjustment to or disclosure in the financial statements. Recomputing depreciation related to assets sold after year-end is not likely to provide information about subsequent events. Sales occurring after year-end are not considered to be subsequent events.
Choice "d" is incorrect. Subsequent events are material events or transactions occurring subsequent to the balance sheet date, but prior to the issuance of the financial statements, that require adjustment to or disclosure in the financial statements. Control deficiencies do not fall within this definition, so reperforming tests of controls would not provide evidence about subsequent events.

QUESTION 98
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. A lawsuit is resolved that is explained in a separate paragraph of the prior-year's auditor's report.
B. New information is discovered concerning undisclosed related party transactions of the prior year.
C. A technological development occurs that affects the entity's ability to continue as a going concern.
D. The entity sells a subsidiary that accounts for 35% of the entity's consolidated sales.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. If an auditor becomes aware of material information that existed at the date of the auditor's report, and which would have affected that report, the auditor needs to take appropriate action.
Since related party transactions should be disclosed in the financial statements, it is likely that the auditor would need to make further inquiries to determine whether the lack of disclosure will affect the previously issued report. Choice "a" is incorrect. Resolution of a lawsuit that was disclosed in the prior year's audit report would not be likely to affect the audit report, as auditors are not required to update their reports for events occurring after the fact.
Choice "c" is incorrect. A technological development that affects the entity's ability to continue as a going concern would not be likely to affect the previous year's audit report, as auditors are not required to update their reports for events occurring after the fact.
Choice "d" is incorrect. Sale of a subsidiary would not be likely to affect the previous year's audit report, as auditors are not required to update their reports for events occurring after the fact.

QUESTION 99
On February 9, Brown, CPA, expressed an unqualified opinion on the financial statements of Web Co. On October 9, during a peer review of Brown's practice, the reviewer informed Brown that engagement personnel failed to perform a search for subsequent events for the Web engagement. Brown should first:

A. Request Web's permission to perform substantive procedures that would provide a satisfactory basis for the opinion.
B. Inquire of Web whether there are persons currently relying, or likely to rely, on the financial statements.
C. Take no additional action because subsequent events have no effect on the financial statements that were reported on.
D. Assess the importance of the omitted procedures to Brown's present ability to support the opinion.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. If an omitted audit procedure is discovered, the auditor should assess the importance of the omitted procedure to the auditor's ability to support the opinion. It might be the case that other audit procedures tended to compensate for the omitted procedure, in which case no further action would be necessary.
Choice "a" is incorrect. The auditor would only request permission to perform substantive procedures if no other procedures compensated for the missing one, and if there were persons relying (or likely to rely) on the financial statements. Choice "b" is incorrect. The auditor would need to determine whether there were persons relying (or likely to rely) on the financial statements, but this would not be done unless it had already been determined that no other audit procedures compensated for the missing one.
Choice "c" is incorrect. If the omitted audit procedure impairs the auditor's ability to support the opinion, no other procedures compensated for the missing one, and there were persons relying (or likely to rely) on the financial statements, the auditor would need to apply substantive procedures. Taking no action would not be an acceptable response. Reporting on Other Information

QUESTION 100
Which of the following is not true regarding an engagement to provide a written report on the application of accounting principles?

A. An accountant is prohibited from providing a report on the application of accounting principles to a transaction not involving the facts and circumstances of a specific entity.
B. The accountant's written report on the application of accounting principles should include an identification of the specific entity involved.
C. An accountant is prohibited from providing a report on the application of accounting principles to a proposed future transaction involving the facts and circumstances of a specific entity.
D. The accountant's written report on the application of accounting principles should include a paragraph restricting the use of the report.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. An accountant may report on the application of accounting principles to a proposed future transaction as long as the transaction involves the facts and circumstances of a specific entity.
Choice "a" is incorrect. An accountant is prohibited from providing a report on the application of accounting principles to "hypothetical transactions," which are defined as those not involving the facts and circumstances of a specific entity. Choices "b" and "d" are incorrect. The accountant's written report on the application of accounting principles should include an identification of the specific entity involved, a description of the transaction(s), a statement of the relevant facts, circumstances, and assumptions (and a statement that any changes therein may change the report), a statement about the source of the information, a statement describing the appropriate accounting principles or type of opinion that may be rendered, the reasons for the accountant's conclusions, a statement regarding management's responsibility, and a restrictive use paragraph.

QUESTION 101
Before reporting on the financial statements of a U.S. entity that have been prepared in conformity with another country's accounting principles, an auditor practicing in the U.S. 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.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Before reporting on the financial statements of a U.S. entity that have been prepared in conformity with another country's accounting principles, the auditor practicing in the U.S. should understand the accounting principles generally accepted in the other country.
Choice "b" is incorrect. The auditor practicing in the U.S. would be able to report on the financial statements of the U.S. entity without obtaining certification in the other country. Choice "c" is incorrect. The auditor need not disclaim an opinion on the financial statements prepared in conformity with another country's accounting principles. Choice "d" is incorrect. A waiver to perform the engagement is not necessary.

QUESTION 102
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.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The accountant's report on the application of accounting principles should include a statement that should any facts or circumstances differ from those presented to the accountant, the accountant's conclusions may change.
Choice "b" is incorrect. The report should state that the engagement was performed in accordance with "AICPA Standards," not statements on Standards for Consulting Services.
Choice "c" is incorrect. The report's use is restricted to "specified parties," which may include parties other than management (e.g., the board of directors). Also, the preparers of the financial statements and the reporting accountant should consult with the entity's continuing accountant.
Choice "d" is incorrect. The report does not provide negative assurance with respect to GAAP; rather, it may describe the appropriate accounting principles to be applied.

QUESTION 103
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 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 general use of all interested parties.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. When rendering an opinion on the application of accounting principles to a specific transaction, the reporting CPA should consult with the continuing CPA to obtain information relevant to the transaction.
Choice "b" is incorrect. The reporting CPA has no obligation to report the engagement's findings to the continuing CPA. Generally, the report would be addressed to the requesting party (e.g., management, the board of directors, etc.). Choice "c" is incorrect. There is no disclaimer in the report; however, the CPA does state that the preparers of the financial statements are responsible for proper accounting treatment. Choice "d" is incorrect. Use of the report is restricted to specified parties.

QUESTION 104
The financial statements of KCP America, a U.S. entity, are prepared for inclusion in the consolidated financial statements of its non-U.S. 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 U.S.-style report (unmodified).
II. A U.S.-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

A. Option A
B. Option B

C. Option C
D. Option D

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. No - Yes - Yes. When 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, the auditor may report using either a U.S.-style report modified to report on the accounting principles of the parent's country or the report form of the parent's country. Choices "a", "b", and "c" are incorrect, per the above .

QUESTION 105
Which of the following is true regarding the auditor's responsibility to report on information accompanying the basic financial statements in a client-prepared document?

A. The auditor may report on information accompanying the basic financial statements in a clientprepared document only if he or she has been specifically engaged to do so.
B. The auditor is required to express an opinion on whether information accompanying the basic financial statements in a client-prepared document is fairly stated in all material respects in relation to the financial statements taken as awhole.
C. If an auditor chooses to report on information accompanying the basic financial statements in a clientprepared document, the report should include a description of the character of the audit work performed.
D. If an auditor chooses to report on information accompanying the basic financial statements in a clientprepared document, the report should include an opinion on the information but should not describe the character of the audit workperformed.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. If an auditor chooses to report on information accompanying the basic financial statements in a client-prepared document, the report should include a description of both the character of the audit work performed and the degree of responsibility assumed.
Choice "a" is incorrect. There is no requirement that the auditor be specifically engaged to report on such information. If auditing procedures have been applied to the information, the auditor is permitted to report thereon.
Choice "b" is incorrect. The auditor is permitted but not required to report on such information.

Choice "d" is incorrect. If an auditor chooses to report on information accompanying the basic financial statements in a client-prepared document, the report should include an opinion on the information and a description of both the character of the audit work performed and the degree of responsibility assumed.

QUESTION 106
Which of the following reporting options is least likely with regard to supplementary information that is required by GAAP?

A. The auditor's report on the financial statements makes no reference to the supplementary information.
B. A disclaimer of opinion is issued on supplementary information that is not clearly distinguished from the financial statements and is not marked "unaudited."
C. The auditor's report on the financial statements includes both an opinion on the supplementary information and a statement restricting the use of the report.
D. The auditor's report on the financial statements includes an opinion regarding whether the supplementary information is fairly stated in all material respects in relation to the financial statements taken as a whole.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. There is no requirement that the auditor's report on supplementary information required by GAAP be restricted.
Choice "a" is incorrect. An auditor is not required to audit supplementary information, and in such cases the auditor's report on the basic financial statements would not generally include a reference to such information.
Choice "b" is incorrect. When supplementary information that is not clearly distinguished from the financial statements is not marked "unaudited," the auditor would generally issue a disclaimer on that information.
Choice "d" is incorrect. When the auditor chooses to apply auditing procedures to the supplementary information, he or she may express an opinion regarding whether the supplementary information is fairly stated in all material respects in relation to the financial statements taken as a whole.

QUESTION 107
When an auditor submits a document containing audited financial statements to a client, and those financial statements include supplementary information required by GAAP, the auditor may choose any of the following options, except:

A. Express an opinion on the information, if he or she has been engaged to examine such information.
B. Express negative assurance on the information, if review procedures have been appropriately performed.
C. Report on whether the information is fairly stated in relation to the financial statements taken as a whole, if appropriate auditing procedures have been applied.
D. Disclaim an opinion on the information.

Correct Answer: B

Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The auditor would not perform a review or express negative assurance on supplementary information required by GAAP that is included in an auditor-submitted document.
Choice "a" is incorrect. The auditor may express an opinion on the information, if he or she has been engaged to examine it.
Choice "c" is incorrect. The auditor may report on whether the information is fairly stated in relation to the financial statements taken as a whole, if appropriate auditing procedures have been applied. Choice "d" is incorrect. The auditor may disclaim an opinion on the information.

QUESTION 108
An auditor may report on condensed financial statements that are derived from complete financial statements if the:

A. Condensed financial statements are distributed to stockholders along with the complete financial statements.
B. Auditor describes the additional procedures performed on the condensed financial statements.
C. Auditor indicates whether the information in the condensed financial statements is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.
D. Condensed financial statements are presented in comparative form with the prior year's condensed financial statements.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. An auditor may report on condensed financial statements that are derived from financial statements that he or she has audited, indicating (1) that he or she has audited and expressed an opinion on the complete financial statements, (2) the date of the auditor's report, (3) the type of opinion expressed, and (4) that the information contained in the condensed financial statements is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.
Choice "a" is incorrect. The condensed financial statements do not have to be distributed to the stockholders.
Choice "b" is incorrect. The audit report on condensed financial statements does not require that additional procedures be described.
Choice "d" is incorrect. Condensed financial statements do not need to be presented in comparative form with the prior year's financial statements.

QUESTION 109
An auditor is engaged to report on selected financial data that are included in a client-prepared 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 comprehensive basis of accounting other than GAAP.
D. Indicate that the data are not fairly stated in all material respects.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. An auditor's report on selected information included in a client-prepared document containing audited financial statements should be limited to data derived from audited financial statements. Choice "b" is incorrect. It is not necessary to limit distribution of such a report.
Choice "c" is incorrect. Selected financial data is not an "other comprehensive basis of accounting."
Choice "d" is incorrect. The auditor indicates whether the selected financial data is fairly stated, in all material respects, in relation to the financial statements from which it has been derived.

QUESTION 110
If information accompanying the basic financial statements in an auditor-submitted document has been subjected to auditing procedures, the auditor may include in the auditor's report on the financial statements an opinion that the accompanying information is fairly stated in:

A. Accordance with generally accepted auditing standards.
B. Conformity with 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.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. When an auditor submits a document that contains information in addition to the client's basic financial statements, and this information was subjected to auditing procedures, the auditor may include in the auditor's report an opinion that the information is fairly stated in all material respects in

relation to the basic financial statements taken as a whole. This statement would follow the opinion paragraph in the standard report.
Choice "a" is incorrect. Information in an ASD is not stated in an auditor's report to be in accordance with GAAS. Instead, the auditor would state that the "information has been subjected to the auditing procedures applied in the audit of the basic financial statements..."
Choice "b" is incorrect. The auditor would not state that ASD information was fairly stated in accordance with GAAP. The information in an ASD is in addition to that required by GAAP.
Choice "d" is incorrect. Reports on ASD are not "attest engagements."

QUESTION 111
An auditor concludes that there is a material inconsistency in the other information in an annual report to shareholders containing audited financial statements. The auditor believes that the financial statements do not require revision, but the client is unwilling to revise or eliminate the material inconsistency in the other information. Under these circumstances, what action would the auditor most likely take?

A. Consider the situation closed because the other information is not in the audited financial statements.
B. Issue an "except for" qualified opinion after discussing the matter with the client's audit committee.
C. Disclaim an opinion on the financial statements after explaining the material inconsistency in a separate explanatory paragraph.
D. Revise the auditor's report to include a separate explanatory paragraph describing the material inconsistency.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. If the auditor discovers a material inconsistency in other information accompanying the audited financial statements, the financial statements do not require revision, and the client refuses to eliminate or revise the inconsistency, the auditor should consider 1) revising the report to include a separate paragraph describing the inconsistency, 2) withholding the report, or 3) withdrawing from the engagement.
Choice "a" is incorrect. Even though the auditor has no responsibility to audit or otherwise corroborate other information accompanying the financial statements, the auditor has a responsibility to read the other information accompanying the financial statements for consistency and to identify any material misstatements of fact included therein.
Choice "b" is incorrect. A qualified opinion is generally not warranted because the financial statements are fairly stated. Choice "c" is incorrect. A disclaimer of opinion is generally not warranted because there is no limitation on scope.

QUESTION 112
In the standard report on condensed financial statements that are derived from a public entity's audited financial statements, a CPA should indicate that the:

A. Condensed financial statements are prepared in conformity with another comprehensive basis of accounting.
B. CPA has audited and expressed an opinion on the complete financial statements.
C. Condensed financial statements are not fairly presented in all material respects.

D. CPA expresses limited assurance that the financial statements conform with GAAP.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The auditor's report on condensed statements derived from audited statements should indicate (1) that the CPA audited and expressed an opinion on the complete financial statements,
(2) the date of the auditor's report on the complete financial statements, (3) the type of opinion expressed, and (4) whether, in the auditor's opinion, the information set forth in the condensed financial statements is fairly stated in all material respects in relation to the complete financial statements from which it was derived.
Choice "a" is incorrect. Condensed financial statements are not prepared in conformity with a comprehensive basis of accounting other than GAAP.
Choice "c" is incorrect. The auditor's report on condensed financial statements does not indicate whether they are fairly presented in all material respects; rather, the report indicates whether they are fairly presented in relation to the complete financial statements.
Choice "d" is incorrect. The auditor does not express an opinion (or provide any assurance) on whether condensed FS conform with GAAP; only whether such statements are fairly stated in relation to the complete FS.

QUESTION 113
Investment and property schedules are presented for purposes of additional analysis in an auditor submitted document. The schedules are not required parts of the basic financial statements, but accompany the basic financial statements. When reporting on such additional information, the measurement of materiality is the:

A. Same as that used in forming an opinion on the basic financial statements taken as a whole.
B. Lesser of the individual schedule of investments or schedule of property taken by itself.
C. Greater of the individual schedule of investments or schedule of property taken by itself.
D. Combined total of both the individual schedules of investments and property taken as a whole.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. When reporting on additional information accompanying the audited financial statements, the measure of materiality would be the same as that used in forming an opinion on the financial statements taken as a whole. Choices "b", "c", and "d" are incorrect, based on the above .

QUESTION 114
What is an auditor's responsibility for supplementary information which is outside the basic financial statements, but required by the FASB?

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.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. For additional supplementary information required by the FASB, the auditor should apply certain limited procedures to the information, and report deficiencies in or omissions of such information.
Choice "a" is incorrect. Required supplementary information is considered an essential part of financial reporting, and therefore certain limited procedures should be applied by the auditor.
Choice "b" is incorrect. For additional supplementary information required by the FASB, the auditor should apply certain limited procedures to the information, and report deficiencies in or omissions of such information. Choice "d" is incorrect. Certain limited procedures should be applied to required supplementary information, but this information need not be audited.

QUESTION 115
Which of the following best describes the auditor's reporting responsibility concerning information accompanying the basic financial statements in an auditor-submitted document?

A. The auditor has no reporting responsibility concerning information accompanying the basic financial statements.
B. The auditor should report on the information accompanying the basic financial statements only if the auditor participated in its preparation.
C. The auditor should report on the information accompanying the basic financial statements only if the auditor did not participate in its preparation.
D. The auditor should report on all the information included in the document.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. When an auditor submits a document containing audited financial statements to the client or others, the auditor has a responsibility to report on all the information included in the document.
Choice "a" is incorrect. The auditor does have additional reporting responsibilities concerning information that accompanies the basic financial statements in an auditor-submitted document.
Choice "b" is incorrect. The auditor has responsibility to report on any additional information regardless of whether the auditor participated in the preparation of the information. Choice "c" is incorrect. The auditor has reporting responsibilities regardless of whether the auditor participated in the preparation of the information.

QUESTION 116
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 explanatory 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.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The auditor should read the "other information" in a client's document containing audited FS to determine that it is consistent with the audited FS. Choice "a" is incorrect. Performing analytical procedures or any other procedure is not necessary. Choice "b" is incorrect. An explanatory paragraph is not required.
Choice "c" is incorrect. The auditor has no obligation to perform any procedure to corroborate "other information" contained in a document such as an annual report.

QUESTION 117
An auditor may report on condensed financial statements that are derived from complete audited financial statements if the:

A. Auditor indicates whether the information in the condensed financial statements is fairly stated in all material respects.
B. Condensed financial statements are presented in comparative form with the prior year's condensed financial statements.
C. Auditor describes the additional review procedures performed on the condensed financial statements.

D. Condensed financial statements are distributed only to management and the board of directors.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. When reporting on condensed financial statements that are derived from complete audited financial statements, the auditor should indicate in his report whether the information in the condensed financial statements is fairly stated in all material respects (in relation to the basic financial statements taken as a whole).
Choices "b" and "d" are incorrect. There is no requirement that the condensed financial statements be presented in comparative form, or that they be distributed only to management and the board of directors (i.e., distribution is not restricted).
Choice "c" is incorrect. The auditor would not perform or describe additional review procedures related to the condensed financial statements.

QUESTION 118
If management (of a governmental body) declines to present supplementary information required by the Governmental Accounting Standards Board (GASB), the auditor should issue a(an):

A. Adverse opinion.
B. Qualified opinion with an explanatory paragraph.
C. Unqualified opinion.
D. Unqualified opinion with an additional explanatory paragraph.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. If management (of a governmental body) declines to present information required by the GASB, the auditor should issue an unqualified opinion with an additional explanatory paragraph. Choices "a", "b", and "c" are incorrect, per the above .

QUESTION 119
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 audit evidence 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 Statement on segment information.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The auditor's objective is to provide a reasonable basis for concluding whether segment information is presented in conformity with GAAP.
Choice "a" is incorrect. The auditor is not required to see that segment information included is comparable to other enterprises.
Choice "b" is incorrect. Sufficient audit evidence must be obtained to ensure that segment information is presented in accordance with GAAP, not to allow the auditor to be associated with such information. Choice "c" is incorrect. The inclusion of segment information is a GAAP requirement, and a separate opinion is not required.

QUESTION 120
Green, CPA, is requested to render an opinion on the application of accounting principles by an entity that is audited by another CPA. Green may:

A. Not accept such an engagement because to do so would be considered unethical.
B. Not accept such an engagement because Green would lack the necessary information on which to base an opinion without conducting an audit.
C. Accept the engagement but should form an independent opinion without consulting with the continuing CPA.
D. Accept the engagement but should consult with the continuing CPA to ascertain all the available facts relevant to forming a professional judgment.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. A "reporting accountant" (an accountant in public practice who is requested to render an opinion on the application of GAAP by an entity audited by another CPA) may accept the engagement, but should consult with the "continuing CPA" to ascertain the available facts relevant to forming a professional judgment.
Choices "a" and "b" are incorrect. A reporting CPA may accept an engagement to render an opinion on GAAP of an entity audited by another CPA. The reporting CPA should consult with the continuing CPA to obtain pertinent information. Choice "c" is incorrect. The reporting accountant should consult with the continuing accountant to ascertain all the available, relevant facts.

QUESTION 121
In its annual report to shareholders, Lake Co. included a separate management report that contained additional information. Lake's auditor is expressing an unqualified opinion on Lake's financial statements but has not been engaged to examine and report on this additional information. What is the auditor's responsibility concerning such a report?

A. The auditor should add an explanatory paragraph to the report on the financial statements disclaiming an opinion on the additional information.
B. The auditor has no obligation to read the management report or to verify the accuracy or appropriateness of its contents.
C. The auditor should request Lake to place the management report in its annual report where it will not be misinterpreted to be the auditor's assertion.
D. The auditor should read the management report and consider whether it contains a material misstatement of fact.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The auditor should read other information accompanying the basic financial statements and consider whether it contains a material inconsistency or material misstatement of fact.
Choice "a" is incorrect. The auditor generally does not add a disclaimer paragraph in this situation.
Choice "b" is incorrect. The auditor should read other information accompanying the basic financial statements and consider whether it contains a material inconsistency or material misstatement of fact.
Choice "c" is incorrect. Even if the management report were included in the annual report, the auditor still has the same responsibility regarding both the management report and the annual report: the auditor should read the information and consider whether it contains a material inconsistency or material misstatement of fact.

QUESTION 122
An auditor is reporting on condensed financial statements for an annual period that are derived from the audited financial statements of a publicly-held entity. The auditor's opinion should indicate whether the information in the condensed financial statements is fairly stated in all material respects:

A. In conformity with accounting principles generally accepted in the United States of America.
B. In relation to the complete financial statements.
C. In conformity with an other comprehensive basis of accounting.
D. In relation to supplementary filings under federal security statutes.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The auditor should report whether the information in the condensed financial statements is fairly stated, in all material respects, in relation to the financial statements from which it has been derived.
Choice "a" is incorrect. Condensed financial statements do not include all of the disclosures required by GAAP, and therefore would not typically be presented in conformity with GAAP.
Choice "c" is incorrect. Condensed financial statements are presented in less detail than complete financial statements, but the fact pattern gives no indication that any comprehensive basis of accounting other than GAAP has been used. Choice "d" is incorrect. The auditor should report whether the information in the condensed financial statements is fairly stated, in all material respects, in relation to the financial statements from which it has been derived, not in relation to supplementary filings under federal security statutes.

QUESTION 123
An auditor determines that the entity is presenting certain supplementary financial disclosures of pension information that are required by the GASB. Under these circumstances, the auditor should:

A. Add an explanatory paragraph to the auditor's report that refers to the required supplementary information.
B. State that the audit is not being performed in accordance with generally accepted auditing standards.
C. Document in the working papers that the required supplementary information is presented, but should not apply any procedures to the information.
D. Compare the required supplementary information for consistency with the audited financial statements.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The auditor should perform certain limited procedures on supplementary information accompanying the financial statements, including evaluating whether the information is consistent with the audited financial statements.
Choice "a" is incorrect. Generally, the auditor's report on the financial statements would not include a reference to required supplementary information unless there were a problem with it (e.g., it was omitted, inappropriately prepared, or the auditor was unable to satisfactorily complete required procedures).
Choice "b" is incorrect. An audit can and should be performed in accordance with generally accepted auditing standards even when required supplementary information is presented. Choice "c" is incorrect. The auditor should perform certain limited procedures on supplementary information accompanying the financial statements.

QUESTION 124
An auditor reads the letter of transmittal accompanying a county's comprehensive annual financial report and identifies a material inconsistency with the financial

statements. The auditor determines that the financial statements do not require revision. Which of the following actions should the auditor take?

A. Request that the client revise the letter of transmittal.
B. Include an explanatory paragraph in the auditor's report.
C. Consider withdrawing from the engagement.
D. Request a client representation letter acknowledging the inconsistency.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. When information accompanies audited financial statements in a client-prepared document, the auditor is required to read the information. If such information is materially inconsistent with the financial statements and the financial statements do not require revision, the auditor should request that the information (in this case the letter of transmittal) be revised.
Choice "b" is incorrect. The auditor would only revise the report to include discussion of the material inconsistency if the client were unwilling to revise the transmittal letter appropriately.
Choice "c" is incorrect. The auditor would only consider withdrawing from the engagement if the client were unwilling to revise the transmittal letter appropriately.
Choice "d" is incorrect. The auditor would not request a client representation letter acknowledging the inconsistency, as correction (and not simply acknowledgment) of the error is desired.

QUESTION 125
Pell, CPA, decides to serve as principal auditor in the audit of the financial statements of Tech
Consolidated, Inc. Smith, CPA, audits one of Tech's subsidiaries. In which situation(s) should Pell make reference to Smith's audit?
I. Pell reviews Smith's audit documentation and assumes responsibility for Smith's work, but expresses a qualified opinion on Tech's financial statements.
II. Pell is unable to review Smith's audit documentation; however, Pell's inquiries indicate that Smith has an excellent reputation for professional competence and integrity.

A. I only.
B. II only.
C. Both I and II.
D. Neither I nor II.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. **II** only. **I**f Pell is unable to review Smith's audit documentation, but inquiries indicate that Smith has an excellent reputation for professional competence and integrity, Pell should divide responsibility by making reference to Smith's audit.
Choices "a", "c", and "d" are incorrect. Since the principal auditor in situation **I** reviews Smith's audit documentation and assumes responsibility for Smith's work, no mention of Smith should be made.

QUESTION 126
Which of the following best describes what is meant by the term generally accepted auditing standards?

A. Rules acknowledged by the accounting profession because of their universal application.
B. Pronouncements issued by the Auditing Standards Board.
C. Measures of the quality of the auditor's performance.
D. Procedures to be used to gather evidence to support financial statements.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. Generally accepted auditing standards ("GAAS") are measures of the quality of the auditor's performance.
Choice "a" is incorrect. GAAS are not "rules," nor are they universally applicable. GAAS are measures of the quality of an auditor's performance.
Choice "b" is incorrect. The Auditing Standards Board (ASB) issues many types of pronouncements, including (but not limited to) "Statements on Auditing Standards" (SASs). While SASs are considered to be interpretations of GAAS, not all ASB pronouncements relate to audits. Therefore, just because something is issued by the ASB does not make it GAAS.
Choice "d" is incorrect. Auditing standards differ from auditing procedures in that procedures relate to acts to be performed, whereas standards deal with the quality of the performance of those acts.

QUESTION 127
According to the profession's ethical standards, which of the following events may justify a departure from a Statement of Financial Accounting Standards?

	New legislation	Evolution of a new form of business transaction
A.	No	Yes
B.	Yes	No
C.	Yes	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. Yes - Yes. Rule 203 of the code of professional conduct of the AICPA states that if the financial statements or data contain a GAAP departure, the departure may be justified if the CPA can demonstrate that due to unusual circumstances, such as new legislation or the evolution of a new form of business transaction, the FS would otherwise be misleading.
Under these circumstances, the auditor's report should describe the departure, its approximate effects, if practicable, and the reasons why compliance with the generally accepted principle would result in a misleading statement. Choices "a", "b", and "d" are incorrect, per the above .

QUESTION 128
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.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Negative cash flows from operating activities most likely would cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.
Choices "b" and "d" are incorrect. Plans to reduce or delay cash expenditures are mitigating factors conserving cash (e.g., postponing R&D projects and replacing cash dividends with stock dividends). This would not ordinarily cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.
Choice "c" is incorrect. The existence of significant related party transactions should be disclosed but would not ordinarily cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.

QUESTION 129
For an entity that does not receive governmental financial assistance, an auditor's standard report on financial statements generally would not refer to:

A. Significant estimates made by management.
B. An assessment of the entity's accounting principles.
C. Management's responsibility for the financial statements.
D. The entity's internal control.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The auditor's standard report generally does not make reference to the entity's internal control. Note that for an entity that does receive governmental financial assistance, a written report on internal control is required. Also, note that an auditor may (but is not required to) expand his or her audit report to clarify that a GAAS audit does not require the level of testing and reporting on internal control that is required for issuers. Choices "a" and "b" are incorrect. The scope paragraph states that, "an audit also includes assessing the accounting principles used and significant estimates made by management." Choice "c" is incorrect. The introductory paragraph states that the "financial statements are the responsibility of the company's management."

QUESTION 130
Which of the following procedures should an auditor generally perform regarding subsequent events?

A. Compare the latest available interim financial statements with the financial statements being audited.
B. Send second requests to the client's customers who failed to respond to initial accounts receivable confirmation requests.
C. Communicate material weaknesses in the internal control structure to those charged with governance.
D. Review the cut-off bank statements for several months after the year-end.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. When performing procedures regarding subsequent events, the auditor generally will compare the latest available interim financial statements with the financial statements being audited to determine if any significant subsequent event occurred that would need to be reflected in the statements being audited.
Choice "b" is incorrect. Sending second requests to the client's customers who failed to respond to initial A/R confirmation requests is a substantive procedure that provides evidence about receivables existing at year end, not about subsequent events.
Choice "c" is incorrect. Internal control weaknesses should be communicated to those charged with governance, but this communication provides no evidence about subsequent events.
Choice "d" is incorrect. Bank cut-off statements generally are reviewed for only a week to ten days subsequent to year-end. Reviewing them for a longer period such as "several months" would provide little additional audit evidence regarding the YE FS and thus would not be a cost beneficial procedure.

QUESTION 131
An auditor's report contains the following sentences:
We did not audit the financial statements of JK Co., a wholly owned subsidiary, which statements reflect total assets and revenues constituting 17 percent and 19 percent, 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 JK Co., is based solely on the report of the other auditors. These sentences:

A. Are an improper form of reporting.
B. Divide responsibility.
C. Disclaim an opinion.
D. Qualify the opinion.

Correct Answer: B

Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The report indicates a division of responsibility.
Choice "a" is incorrect. Words describing the percentages of revenues and assets audited by other auditors are proper in dividing responsibility.
Choice "c" is incorrect. Dividing responsibility does not affect the unqualified opinion, nor does it require a disclaimer of opinion. Choice "d" is incorrect. Dividing responsibility does not affect the unqualified opinion, nor does it require a qualified opinion.

QUESTION 132
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. No âˆ' No.

A qualified opinion phrase is, "in our opinion, except for [of problem] as discussed in the preceding paragraph . . ."
Choice "a" is incorrect, as "when read in conjunction with Note X" is not a phrase included in the opinion paragraph of a qualified opinion.
Choice "b" is incorrect, as "with the foregoing " is not a phrase included in the opinion paragraph of a qualified opinion.
Choice "c" is incorrect. Neither phrase is included in the opinion paragraph of a qualified opinion.
(This is why it's important to memorize the qualifying phrases as well as the standard independent auditor's report.)

QUESTION 133
Which of the following procedures would an auditor most likely perform to obtain evidence about the occurrence of subsequent events?

A. Recomputing a sample of large-dollar transactions occurring after year-end for arithmetic accuracy.
B. Investigating changes in stockholders' equity occurring after year-end.
C. Inquiring of the entity's legal counsel concerning litigation, claims, and assessments arising after yearend.
D. Confirming bank accounts established after year-end.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. The auditor would most likely inquire of the entity's legal counsel concerning litigation, claims and assessments arising after year-end in order to obtain evidence about the occurrence of subsequent events. Claims arising after year-end might well impact the year-end financial statements.
Choice "a" is incorrect. Recomputing a sample of large-dollar transactions occurring after year-end for arithmetic accuracy would not provide evidence about year-end amounts.
Choice "b" is incorrect. The auditor would inquire about changes in stockholders' equity occurring after year-end, but would not generally perform an investigation of such items.
Choice "d" is incorrect. Confirming bank accounts established after year-end is generally not done (only those in existence at year-end are confirmed). Accounts established after year-end generally would not be relevant to year-end amounts.

QUESTION 134
What is an auditor's responsibility for supplementary information required by the GASB that is placed outside the basic financial statements?

A. Label the information as unaudited and expand the auditor's report to include a disclaimer on the information.
B. Add an explanatory paragraph to the auditor's report and refer to the information as "required supplementary information."
C. Apply limited procedures to the information and report deficiencies in, or the omission of, the information.
D. Audit the required supplementary information in accordance with generally accepted governmental auditing standards.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. With respect to supplementary information required by the GASB that is placed outside the basic financial statements, the auditor should apply limited procedures to the information (to determine that it is consistent with the basic audited financial statements) and report deficiencies in or the omission of the information (via an explanatory paragraph).
Choice "a" is incorrect. If the information is labeled "unaudited," a disclaimer generally would not be necessary.
Choice "b" is incorrect. The explanatory paragraph is only added if the supplemental information required by the GASB is deficient, omitted entirely, if the auditor cannot complete procedures, or if there is doubt about conformity with guidelines.
Choice "d" is incorrect. The supplementary information required by the GASB is not required to be audited since it is placed outside of the basic financial statements; however, an opinion is permitted.

QUESTION 135
An auditor's responsibility to express an opinion on the financial statements is:

A. Implicitly represented in the auditor's standard report.
B. Explicitly represented in the opening paragraph of the auditor's standard report.
C. Explicitly represented in the scope paragraph of the auditor's standard report.
D. Explicitly represented in the opinion paragraph of the auditor's standard report.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The auditor's responsibility to express an opinion on the FS is explicitly represented in the last sentence of the opening paragraph: "Our responsibility is to express an opinion on these financial statements based on our audit."
Choice "a" is incorrect. The responsibility to express an opinion is explicitly represented (i.e., clearly stated), not implicitly represented (i.e., assumed).
Choice "c" is incorrect. There are no words in the scope paragraph that represent an auditor's responsibility to express an opinion.
Choice "d" is incorrect. The opinion paragraph includes the auditor's opinion, but does not specifically mention the auditor's responsibility to express an opinion.

QUESTION 136
When an independent CPA assists in preparing the financial statements of a publicly held entity, but has not audited or reviewed them, the CPA should issue a

disclaimer of opinion. In such situations, the CPA has no responsibility to apply any procedures beyond:

A. Ascertaining whether the financial statements are in conformity with generally accepted accounting principles.
B. Determining whether management has elected to omit substantially all required disclosures.
C. Documenting that the internal control structure is not being relied on.
D. Reading the financial statements for obvious material misstatements.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. When an independent CPA assists in preparing the FS of a publicly held entity, but has not "audited" or "reviewed" them, the CPA should issue a disclaimer of opinion and has only the responsibility to read the FS for obvious material misstatements.
Choice "a" is incorrect. A disclaimer does not require ascertaining whether the FS are in conformity with GAAP.
Choice "b" is incorrect. A disclaimer does not require ascertaining whether management has elected to omit substantially all required disclosures. Choice "c" is incorrect. A disclaimer of opinion does not require ascertaining whether or not the internal control structure is being relied upon.

QUESTION 137
An auditor issued an audit report that was dual dated for a subsequent event occurring after the original date of the auditor's report. The auditor's responsibility for events occurring subsequent to the original date was:

A. Extended to subsequent events occurring through the date of reissuance of the report.
B. Extended to include all events occurring since the original date of the auditor's report.
C. Limited to the specific event referenced.
D. Limited to include only events occurring up to the date of the last subsequent event referenced.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. When an auditor issues a report that is dual dated for a subsequent event occurring after the original date of the auditor's report, the auditor's responsibility for events occurring subsequent to the original date of the auditor's report is limited to the specific event referenced.

Choices "a", "b", and "d" are incorrect. The auditor takes responsibility for only the specific event noted in the dual dating and for no other event occurring subsequent to the original date of the auditor's report.

QUESTION 138
An auditor most likely would issue a disclaimer of opinion because of:

A. Inadequate disclosure of material information.
B. The omission of the statement of cash flows.
C. A material departure from generally accepted accounting principles.
D. Management's refusal to furnish written representations.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Management's refusal to furnish written representations is a significant client imposed restriction on the scope of an audit, ordinarily warranting a disclaimer of opinion.
Choice "a" is incorrect. Inadequate disclosure would result in a qualified or adverse opinion.
Choice "b" is incorrect. A qualified report would be appropriate when a "statement of cash flows" is omitted and the scope of the audit is not restricted. Choice "c" is incorrect. A departure from GAAP would result in either a qualified or adverse opinion, depending on materiality.

QUESTION 139
When an auditor qualifies an opinion because of the inability to confirm accounts receivable by direct communication with debtors, the wording of the opinion paragraph of the auditor's report should indicate that the qualification pertains to the:

A. Limitation on the auditor's scope.
B. Possible effects on the financial statements.
C. Lack of sufficient appropriate audit evidence.
D. Departure from generally accepted auditing standards.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. When an auditor qualifies his or her opinion because of a scope limitation, such as the inability to confirm A/R, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the FS and not to the scope limitation itself.
The opinion paragraph should not refer to the scope limitation itself, the lack of evidence, or the departure from GAAS. Choices "a", "c", and "d" are incorrect, based on the above .

QUESTION 140
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.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. The adverse effects of events causing an auditor to believe there is a substantial doubt about an entity's ability to continue as a going concern would most likely be mitigated by evidence relating to the marketability of assets that management plans to sell. By providing evidence that there is a ready market for assets that could be converted to cash, management has demonstrated that the company could remain in operation for a longer period of time, thereby mitigating the need for an explanatory paragraph describing the matter.
Choices "a", "b", and "d" are incorrect. Evidence regarding the ability to expand operations into new product lines in the future, the feasibility of plans to purchase leased equipment at less than market value, or committed arrangements to convert preferred stock to long-term debt would not be sufficient to mitigate doubts about an entity's ability to continue as a going concern, unless it could also be demonstrated that the events would provide adequate cash flow to fund operations for at least the next year.

QUESTION 141
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 unqualified with an explanatory paragraph added.
B. Disclaimer and unqualified with an explanatory paragraph added.
C. Qualified and adverse.

D. Qualified and disclaimer.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. When an auditor is unable to obtain audited financial statements or other evidence supporting an entity's investment in a subsidiary (foreign or domestic), the auditor should issue a qualified or disclaimer of opinion depending on the materiality of the investment in the subsidiary.
Choices "a", "b", and "c" are incorrect. An adverse opinion is only issued when the FS are not presented fairly in conformity with GAAP, and an unqualified opinion with an explanatory paragraph is not appropriate for a scope limitation.

QUESTION 142
Which of the following standards requires a critical review of the work done and the judgment exercised by those assisting in an audit at every level of supervision?

A. Proficiency.
B. Audit risk.
C. Inspection.
D. Due care.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The third general standard is: "The auditor must exercise due professional care in the planning and performance of the audit and the preparation of the report." This standard is interpreted to require a critical review of the work performed and the judgment exercised at every level of supervision.
Choice "a" is incorrect. Proficiency relates to the first general standard (technical training and proficiency of an auditor).
Choice "b" is incorrect. Audit risk and materiality underlie the application of all the standards of fieldwork and reporting, but are not standards themselves. Choice "c" is incorrect. Inspection pertains to the audit evidence standard, which is the third standard of fieldwork.

QUESTION 143
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.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. When an auditor discovers the omission of an audit procedure related to a previously issued report, the auditor should first assess the importance of the omitted procedure to the auditor's ability to support the previously expressed opinion.
Choice "a" is incorrect. The auditor would request the permission of the client to undertake the confirmation of accounts receivable only after determining that the procedure was necessary to support the previously expressed opinion and no other alternative procedure had been performed.
Choice "b" is incorrect. Alternative procedures would be performed only after the auditor determined that the procedure was necessary to support the previously expressed opinion. Choice "d" is incorrect. The auditor needs to be able to support (or revise) the previously issued opinion regardless of whether or not there are persons currently relying on it.

QUESTION 144
Which of the following procedures would an auditor ordinarily perform during the review of subsequent events?

A. Review the cut-off bank statements for the period after the year-end.
B. Inquire of the client's legal counsel concerning litigation.
C. Investigate significant deficiencies in internal control previously communicated to the client.
D. Analyze related party transactions to discover possible irregularities.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. An auditor would most likely obtain a letter from the entity's legal counsel describing any pending litigation, unasserted claims, or loss contingencies, to obtain evidence that might impact the year-end financial statements.
Choice "a" is incorrect. Reviewing cut-off bank statements for the period after year-end generally is performed to evaluate the year-end cash balance, not to

identify subsequent events.
Choice "c" is incorrect. Investigating significant deficiencies in internal control previously communicated to the client would be a procedure performed as part of the planning process and would provide the auditor with information regarding the internal control structure, not subsequent events.
Choice "d" is incorrect. Analyzing related party transactions to discover possible irregularities generally is performed to evaluate financial statement disclosure, not to identify subsequent events.

QUESTION 145
An annual shareholders' report includes audited financial statements and contains supplementary information required by GAAP. Is it permissible for the auditor to report on such information?

A. No, because such reporting may lead to the belief that the auditor is responsible for the information.
B. No, because the auditor has no responsibility to read the other information in a document containing audited financial statements.
C. Yes, provided the report provides negative assurance only.
D. Yes, provided the auditor performs sufficient audit procedures to determine whether the information is fairly stated, in all material respects, in relation to the financial statements.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. If the auditor performs sufficient procedures, he or she may report on whether the information is fairly stated, in all material respects, in relation to the financial statements.
Choices "a" and "b" are incorrect. The auditor may report on such information.
Choice "c" is incorrect. The report provides positive assurance about whether the information is fairly stated, in all material respects, in relation to the financial statements.

QUESTION 146
Tech Company has disclosed an uncertainty due to pending litigation. The auditor's decision to issue a qualified opinion rather than an unqualified opinion most likely would be determined by the:

A. Lack of sufficient evidence.
B. Inability to estimate the amount of loss.
C. Entity's lack of experience with such litigation.
D. Lack of insurance coverage for possible losses from such litigation.

Correct Answer: A

Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Lack of sufficient evidence to support management's assertions would most likely cause an auditor to issue a qualified or disclaimer of opinion.
Choice "b" is incorrect. As long as it is fully disclosed, an inability to estimate the amount of loss from a future event (outcome of pending legislation) would most likely result in an unqualified opinion. Choices "c" and "d" are incorrect. Neither a lack of experience nor a lack of insurance coverage would impact the auditor's report.

QUESTION 147
It is not appropriate to refer a reader of an auditor's report to a financial statement footnote for details concerning:

A. Subsequent events.
B. The pro forma effects of a business combination.
C. Sale of a discontinued operation.
D. The results of confirmation of receivables.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Details concerning the results of audit procedures (such as the results of confirmation of receivables) generally do not appear in the footnotes.
Choice "a" is incorrect. Subsequent events may be discussed in an explanatory paragraph of the auditor's report, which would also refer to the related footnote.
Choice "b" is incorrect. The pro forma effects of a business combination may be included in an explanatory paragraph of the auditor's report, which would also refer to the related footnote. Choice "c" is incorrect. Sale of a discontinued operation may be discussed in an explanatory paragraph of the auditor's report, which would also refer to the related footnote.

QUESTION 148
Morris, CPA, suspects that a pervasive scheme of illegal bribes exists throughout the operations of Worldwide Import-Export, Inc., a new audit client. Morris notified the audit committee and Worldwide's legal counsel, but neither could assist Morris in determining whether the amounts involved were material to the financial statements or whether senior management was involved in the scheme. Under these circumstances, Morris should:

A. Express an unqualified opinion with a separate explanatory paragraph.
B. Disclaim an opinion on the financial statements.
C. Express an adverse opinion on the financial statements.
D. Issue a special report regarding the illegal bribes.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. Since the CPA could not determine whether the suspected illegal bribes were material to the financial statements, or whether senior management was involved in the scheme, Morris should disclaim an opinion on the financial statements.
Choice "a" is incorrect. An unqualified opinion with a separate explanatory paragraph is not appropriate if suspected material illegal bribes cannot be disproven.
Choice "c" is incorrect. An adverse opinion is inappropriate since the suspected material illegal bribes have not been proven, nor has any material effect on the financial statements been determined. Choice "d" is incorrect. Special reports are not issued regarding illegal bribes.

QUESTION 149
The first general standard requires that an audit of financial statements is to be performed by a person or persons having:

A. Seasoned judgment in varying degrees of supervision and review.
B. Adequate technical training and proficiency.
C. Knowledge of the standards of fieldwork and reporting.
D. Independence with respect to the financial statements and supplementary disclosures.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The "first" general standard states that the auditor must have adequate technical training and proficiency to perform the audit.
Comment: It is important to memorize the 10 auditing standards.
Choices "a", "c", and "d" are incorrect, as they do not represent a requirement of the first general standard of reporting.

QUESTION 150
An auditor's report that refers to the use of an accounting principle at variance with generally accepted accounting principles contains the words, "In our opinion,

with the foregoing , the financial statements referred to above present fairly...." This is considered an:

A. Adverse opinion.
B. "Except for" qualified opinion.
C. Unqualified opinion with an explanatory paragraph.
D. Example of inappropriate reporting.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. "In our opinion, with the foregoing , the FS referred to above present fairly" is an example of inappropriate reporting. When an auditor's report refers to the use of an accounting principle at variance with GAAP, the words, "in our opinion, except for the effects of the matters discussed in the preceding paragraph, the FS referred to above present fairly,..." should be used.
Choice "a" is incorrect. An adverse opinion would include the phrase, "...do not present fairly..."
Choice "b" is incorrect. A qualified opinion would include the phrase, "In our opinion, except for the [problem] discussed in the preceding paragraph,..." Choice "c" is incorrect. An unqualified opinion would not include the phrase "with the foregoing " in an explanatory paragraph.

QUESTION 151
Management of Hill Company has decided not to account for a material transaction in accordance with the provisions of an FASB Standard. In setting forth its reasons in a note to the financial statements, management has clearly demonstrated that due to unusual circumstances the financial statements presented in accordance with the FASB Standard would be misleading. The auditor's report should include a separate explanatory paragraph and contain a(an):

A. "Except for" qualified opinion.
B. "Subject to" qualified opinion.
C. Adverse opinion.
D. Unqualified opinion.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. In unusual circumstances, where the literal application of accounting standards would make the FS misleading (e.g., new legislation or new

business practices), the proper accounting treatment is that which will more fairly present the FS. In such a case, the auditor should express an unqualified opinion on the financial statements and include a separate explanatory paragraph.
Choice "a" is incorrect. Under the circumstances, the method of accounting selected by the client is justified. There is no need for an "except for" qualification.
Choice "b" is incorrect. "Subject to" opinions are not acceptable under any circumstances.
Choice "c" is incorrect. An adverse opinion is not appropriate since the financial statements as prepared by the client are fairly presented.

QUESTION 152
A former client requests a predecessor auditor to reissue an audit report on a prior period's financial statements. The financial statements are not restated and the report is not reviseD. What date(s) should the predecessor auditor use in the reissued report?

A. The date of the prior-period report.
B. The date of the client's request.
C. The date of reissue.
D. The dual-dates.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The date of the prior-period report should be used as long as the FS are not restated, the report is not revised, and no significant changes have occurred that would affect the prior FS.
Choices "b" and "c" are incorrect. Using the date of the client's request or the date of reissue would extend the auditor's responsibility to that date.
Choice "d" is incorrect. The auditor may dual date the report if a material subsequent event has occurred, but dual dating is not used for reissuing a report.

QUESTION 153
Does an auditor make the following representations explicitly or implicitly when issuing the standard auditor's report on comparative financial statements?

	Consistent application of accounting principles	Examination of evidence on a test basis
A.	Explicitly	Explicitly
B.	Implicitly	Implicitly
C.	Implicitly	Explicitly
D.	Explicitly	Implicitly

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. Implicitly - Explicitly.
When issuing the standard auditor's report on comparative FS, an auditor implicitly represents consistent application of GAAP, but explicitly states, "An audit includes examining, on a test basis, evidence supporting . . ." (Again, it is essential that you memorize the "auditor's standard report.") Choices "a", "b", and "d" are incorrect, based on the above .

QUESTION 154
An auditor may issue a qualified opinion under which of the following circumstances?

	Lack of sufficient appropriate audit evidence	Restrictions on the scope of the audit
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Yes - Yes.
An auditor may issue a qualified opinion (or a disclaimer, depending on materiality) when there is a lack of sufficient appropriate audit evidence, or when there are restrictions on the scope of the audit. Choices "b", "c", and "d" are incorrect, as explained above.

QUESTION 155
Grant Company's financial statements adequately disclose uncertainties that concern future events, the outcome of which are not susceptible of reasonable estimation. The auditor's report should include a (an):

A. Unqualified opinion.
B. "Subject to" qualified opinion.
C. "Except for" qualified opinion.
D. Adverse opinion.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The auditor should issue an "unqualified opinion" when management adequately discloses future events, the outcome of which are not susceptible of reasonable estimation. No reference to the uncertainty need be made in the auditor's opinion.
Choice "b" is incorrect. "Subject to" qualified opinions are not permitted.
Choice "c" is incorrect. An "except for" qualified opinion would not be used as there is adequate disclosure and there are no scope limitations. Choice "d" is incorrect. An adverse opinion would not be used because the FS are presented "fairly" in conformity with GAAP.

QUESTION 156
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:

Section: Volume A

Choice "a" is correct. The responsibility of the auditor and the responsibility of management are stated explicitly in the introductory paragraph of the standard auditor's report. Choices "b", "c", and "d" are incorrect, as explained above.

QUESTION 157
When there is a significant change in accounting principle, an auditor's report should refer to the lack of consistency in:

A. The scope paragraph.
B. An explanatory paragraph between the second paragraph and the opinion paragraph.
C. The opinion paragraph.
D. An explanatory paragraph following the opinion paragraph.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. When there is a significant change in accounting principle, the auditor's report should refer to the lack of consistency in an explanatory paragraph following the opinion paragraph. The explanatory paragraph should identify the change and refer to the note in the FS that discusses the change in detail. The auditor's concurrence with the change in GAAP is implicit, unless he or she takes exception. Choice "a" is incorrect. Lack of consistency is not a scope limitation.
Choice "b" is incorrect. An explanatory paragraph is often inserted between the second paragraph and opinion paragraph. However, where a change is accounted for in accordance with GAAP, the explanatory paragraph should follow the unqualified opinion paragraph.
Choice "c" is incorrect. The lack of consistency would not be disclosed in an opinion paragraph unless the auditor does not concur and wishes to qualify the opinion. In such case an explanatory paragraph would precede the opinion paragraph and the opinion paragraph would be qualified.

QUESTION 158
When a principal auditor decides to make reference to another auditor's examination, the principal auditor's report should always indicate clearly, in the introductory, scope, and opinion paragraphs, the:

A. Magnitude of the portion of the financial statements examined by the other auditor.
B. Disclaimer of responsibility concerning the portion of the financial statements examined by the other auditor.
C. Name of the other auditor.
D. Division of responsibility.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Reference to the division of responsibility should be made in the introductory, scope and opinion paragraphs of the principal auditor's report. Choice "a" is incorrect. The magnitude of the portion of the FS examined by the other auditor appears only in the introductory paragraph. Choice "b" is incorrect. The principal auditor is not disclaiming responsibility, just dividing it.
Choice "c" is incorrect. The name of the other auditor is generally not mentioned, but may be mentioned with permission and if the other auditor's report is also presented. (Watch out for exclusive words such as "always" or "never.")

QUESTION 159
Information accompanying the basic financial statements in an auditor-submitted document 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 20 years.
D. An analysis of revenue by product line.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. A statement that the "allowance for doubtful accounts is adequate" is generally not included in information accompanying the basic FS in an auditor-submitted document (ASD) because it expresses an opinion rather than providing details or s.
Choices "a", "c", and "d" are incorrect, because the following information, which contains additional details or s, may accompany the basic FS in an ASD:
A. An analysis of inventory by location.
C. Depreciable lives of assets.
D. An analysis of revenue by product line.

QUESTION 160
For a particular entity's financial statements to be presented fairly in conformity with generally accepted accounting principles, it is not required that the principles selected:

A. Be appropriate in the circumstances for the particular entity.

B. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
C. Present information in the financial statements that is classified and summarized in a reasonable manner.
D. Be applied on a basis consistent with those followed in the prior year.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. For a particular entity's FS to be presented fairly in conformity with GAAP, it is not required that the principles selected be applied on a basis consistent with those followed in the prior year, merely that any changes in accounting principle be properly accounted for and disclosed.
Choice "a" is incorrect. The principles selected must be appropriate in the circumstances for the particular entity.
Choice "b" is incorrect. The principles selected must reflect transactions in a manner that present the FS within a range of acceptable limits.
Choice "c" is incorrect. The principles selected must present information in the FS that is classified and summarized in a reasonable manner.

QUESTION 161
An auditor has been asked to report on the balance sheet of Kane Company but not on the other basic financial statements. The auditor will have access to all information underlying the basic financial statements. Under these circumstances, the auditor:

A. May accept the engagement because such engagements merely involve limited reporting objectives.
B. May accept the engagement but should disclaim an opinion because of an inability to apply the procedures considered necessary.
C. Should refuse the engagement because there is a client-imposed scope limitation.
D. Should refuse the engagement in accordance with generally accepted auditing standards.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The auditor may accept the engagement because there is no scope limitation, merely a limited reporting objective. It is acceptable to give an opinion on one FS and not report on the other FS, if the scope is not limited. Choices "b" and "c" are incorrect. The client is not imposing any audit scope limitations. Choice "d" is incorrect. A limited reporting objective is not a departure from GAAS.

QUESTION 162

If an accounting change has no material effect on the financial statements in the current year, but the change is reasonably certain to have a material effect in later years, the change should be:

A. Treated as a consistency modification in the auditor's report for the current year.
B. Disclosed in the notes to the financial statements of the current year.
C. Disclosed in the notes to the financial statements and referred to in the auditor's report for the current year.
D. Treated as a subsequent event.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. If an accounting change does not have a material effect on the FS of the current year, it will be disclosed in the notes to the FS for the current year, but no modification of the auditor's report is necessary.
Choices "a" and "c" are incorrect. If the change in accounting principle were material for the current year, it would be treated as a consistency modification in the auditor's report for the current year. Since there is no material effect in the current year, no modification to the auditor's report is required.
Choice "d" is incorrect. A change in accounting principle is not a "subsequent event."

QUESTION 163
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 management's assertions.
C. Design the audit to detect all instances of illegal acts.
D. Attain the proper balance of professional experience and formal education.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. To exercise due professional care, an auditor should critically review the judgment exercised by those assisting in the audit.
Choice "b" is incorrect. An auditor examines some (but not all) available corroborating evidence supporting management's assertions. Examination of all

evidence would not be feasible.
Choice "c" is incorrect. An auditor has a reasonable responsibility to design the audit to detect material instances of illegal acts, errors, and irregularities. It would not be feasible to design an audit to detect all instances of illegal acts. Choice "d" is incorrect. "Due professional care" pertains to the performance of the audit and the preparation of the report. The training standard relates to the balance of professional experience and formal education of those performing the audit.

QUESTION 164
This question-presents independent factual situations an auditor might encounter in conducting an audit. List A represents the types of opinions the auditor ordinarily would issue. Select as the best answer for this item, the action the auditor normally would take. The types of opinions in List A may be selected once, more than once, or not at all.
Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.
Item to Be Answered
In auditing the long-term investments account, an auditor is unable to obtain audited financial statements for an investee located in a foreign country. The auditor concludes that sufficient appropriate audit evidence regarding this investment cannot be obtained.
List A
Types of Options

A. An "except for" qualified opinion.
B. An unqualified opinion.
C. An adverse opinion.
D. A disclaimer of opinion.
E. Either an "except for" qualified opinion or an adverse opinion.
F. Either a disclaimer of opinion or an "except for" qualified opinion.
G. Either an adverse opinion or a disclaimer of opinion.

Correct Answer: F
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "F" is the correct opinion. This is a scope limitation. Either a disclaimer of opinion (if the item is very material) or an "except for" qualified opinion (if the item is material) should be issued.

QUESTION 165
This question-presents independent factual situations an auditor might encounter in conducting an audit. List B represents the report modifications (if any) that would be necessary. Select as the best answer for each item, the action the auditor normally would take. The report modifications in List B may be selected once, more than once, or not at all.
Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.
Item to Be Answered
In auditing the long-term investments account, an auditor is unable to obtain audited financial statements for an investee located in a foreign country. The auditor concludes that sufficient appropriate audit evidence regarding this investment cannot be obtained.
List B
Report Modifications

A. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph without modifying the three standard paragraphs.
B. Describe the circumstances in an explanatory paragraph following the opinion paragraph without modifying the three standard paragraphs.
C. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the opinion paragraph.
D. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the opinion paragraph.
E. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the scope and opinion paragraphs.
F. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the scope and opinion paragraphs.
G. Describe the circumstances within the scope paragraph without adding an explanatory paragraph.
H. Describe the circumstances within the opinion paragraph without adding an explanatory paragraph.
I. Describe the circumstances within the scope and opinion paragraphs without adding an explanatory paragraph.
J. Issue the standard auditor's report without modification.

Correct Answer: E
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "E" is the correct modification. The situation calls for a qualified opinion or a disclaimer of opinion, but none of the choices adequately describes a disclaimer. Therefore, a qualified opinion is the best answer. The circumstances should be described in an explanatory paragraph preceding the opinion paragraph and the scope and opinion paragraphs should be modified.

QUESTION 166
This question-presents independent factual situations an auditor might encounter in conducting an audit. List A represents the types of opinions the auditor ordinarily would issue. Select as the best answer for this item, the action the auditor normally would take. The types of opinions in List A may be selected once, more than once, or not at all.
Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.
Item to Be Answered
Due to recurring operating losses and working capital deficiencies, an auditor has substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. However, the financial statement disclosures concerning these matters are adequate.
List A
Types of Options

A. An "except for" qualified opinion.
B. An unqualified opinion.
C. An adverse opinion.
D. A disclaimer of opinion.
E. Either an "except for" qualified opinion or an adverse opinion.
F. Either a disclaimer of opinion or an "except for" qualified opinion.
G. Either an adverse opinion or a disclaimer of opinion.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "B" is the correct opinion. In a going concern situation that is properly disclosed, an unqualified opinion should be issued.

QUESTION 167
This question-presents independent factual situations an auditor might encounter in conducting an audit. List B represents the report modifications (if any) that would be necessary. Select as the best answer for each item, the action the auditor normally would take. The report modifications in List B may be selected once, more than once, or not at all.

Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.

Item to Be Answered

Due to recurring operating losses and working capital deficiencies, an auditor has substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. However, the financial statement disclosures concerning these matters are adequate.

List B

Report Modifications

A. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph without modifying the three standard paragraphs.
B. Describe the circumstances in an explanatory paragraph following the opinion paragraph without modifying the three standard paragraphs.
C. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the opinion paragraph.
D. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the opinion paragraph.
E. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the scope and opinion paragraphs.
F. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the scope and opinion paragraphs.
G. Describe the circumstances within the scope paragraph without adding an explanatory paragraph.
H. Describe the circumstances within the opinion paragraph without adding an explanatory paragraph.
I. Describe the circumstances within the scope and opinion paragraphs without adding an explanatory paragraph.
J. Issue the standard auditor's report without modification.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "B" is the correct modification. The circumstances should be described in an explanatory paragraph following the opinion paragraph without modifying the three standard paragraphs.

QUESTION 168

This question-presents independent factual situations an auditor might encounter in conducting an audit. List A represents the types of opinions the auditor ordinarily would issue. Select as the best answer for this item, the action the auditor normally would take. The types of opinions in List A may be selected once, more than once, or not at all.

Assume:

- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.

Item to Be Answered

A principal auditor decides to take responsibility for the work of another CPA who audited a wholly-owned subsidiary of the entity and issued an unqualified opinion. The total assets and revenues of the subsidiary represent 17% and 18%, respectively, of the total assets and revenues of the entity being audited.

List A

Types of Options

A. An "except for" qualified opinion.
B. An unqualified opinion.
C. An adverse opinion.
D. A disclaimer of opinion.
E. Either an "except for" qualified opinion or an adverse opinion.
F. Either a disclaimer of opinion or an "except for" qualified opinion.
G. Either an adverse opinion or a disclaimer of opinion.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "B" is the correct opinion. An unqualified opinion should be issued.

QUESTION 169

This question-presents independent factual situations an auditor might encounter in conducting an audit. List B represents the report modifications (if any) that would be necessary. Select as the best answer for each item, the action the auditor normally would take. The report modifications in List B may be selected once, more than once, or not at all.

Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.

- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.

Item to Be Answered

A principal auditor decides to take responsibility for the work of another CPA who audited a wholly-owned subsidiary of the entity and issued an unqualified opinion. The total assets and revenues of the subsidiary represent 17% and 18%, respectively, of the total assets and revenues of the entity being audited.

List B

Report Modifications

A. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph without modifying the three standard paragraphs.
B. Describe the circumstances in an explanatory paragraph following the opinion paragraph without modifying the three standard paragraphs.
C. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the opinion paragraph.
D. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the opinion paragraph.
E. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the scope and opinion paragraphs.
F. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the scope and opinion paragraphs.
G. Describe the circumstances within the scope paragraph without adding an explanatory paragraph.
H. Describe the circumstances within the opinion paragraph without adding an explanatory paragraph.
I. Describe the circumstances within the scope and opinion paragraphs without adding an explanatory paragraph.
J. Issue the standard auditor's report without modification.

Correct Answer: J
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "J" is the correct modification. When assuming responsibility for another auditor's work, the principal auditor should issue the standard auditor's report without modification.

QUESTION 170

This question-presents independent factual situations an auditor might encounter in conducting an audit.

List A represents the types of opinions the auditor ordinarily would issue. Select as the best answer for this item, the action the auditor normally would take. The types of opinions in List A may be selected once, more than once, or not at all.

Assume:

- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.

- No report modifications are to be made except in response to the factual situation.
Item to Be Answered
An entity issues financial statements that present financial position and results of operations but omits the related statement of cash flows. Management discloses in the notes to the financial statements that it does not believe the statement of cash flows to be a useful financial statement.
List A
Types of Options

A. An "except for" qualified opinion.
B. An unqualified opinion.
C. An adverse opinion.
D. A disclaimer of opinion.
E. Either an "except for" qualified opinion or an adverse opinion.
F. Either a disclaimer of opinion or an "except for" qualified opinion.
G. Either an adverse opinion or a disclaimer of opinion.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "A" is the correct opinion. Failure to include a statement of cash flows is a GAAP violation that requires an "except for" qualified opinion to be issued.

QUESTION 171
This question-presents independent factual situations an auditor might encounter in conducting an audit. List B represents the report modifications (if any) that would be necessary. Select as the best answer for each item, the action the auditor normally would take. The report modifications in List B may be selected once, more than once, or not at all.
Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.
Item to Be Answered
An entity issues financial statements that present financial position and results of operations but omits the related statement of cash flows. Management discloses in the notes to the financial statements that it does not believe the statement of cash flows to be a useful financial statement.

List B
Report Modifications

A. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph without modifying the three standard paragraphs.
B. Describe the circumstances in an explanatory paragraph following the opinion paragraph without modifying the three standard paragraphs.
C. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the opinion paragraph.
D. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the opinion paragraph.
E. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the scope and opinion paragraphs.
F. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the scope and opinion paragraphs.
G. Describe the circumstances within the scope paragraph without adding an explanatory paragraph.
H. Describe the circumstances within the opinion paragraph without adding an explanatory paragraph.
I. Describe the circumstances within the scope and opinion paragraphs without adding an explanatory paragraph.
J. Issue the standard auditor's report without modification.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "C" is the correct modification. The circumstances should be described in an explanatory paragraph preceding the opinion paragraph and the opinion paragraph should be modified.

QUESTION 172
This question-presents independent factual situations an auditor might encounter in conducting an audit. List A represents the types of opinions the auditor ordinarily would issue. Select as the best answer for this item, the action the auditor normally would take. The types of opinions in List A may be selected once, more than once, or not at all.
Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.
Item to Be Answered
An entity changes its depreciation method for production equipment from the straight-line to a units-of production method based on hours of utilization. The auditor concurs with the change although it has a material effect on the comparability of the entity's financial statements.

List A
Types of Options

A. An "except for" qualified opinion.
B. An unqualified opinion.
C. An adverse opinion.
D. A disclaimer of opinion.
E. Either an "except for" qualified opinion or an adverse opinion.
F. Either a disclaimer of opinion or an "except for" qualified opinion.
G. Either an adverse opinion or a disclaimer of opinion.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "B" is the correct opinion. When an accounting change is properly accounted for, an unqualified opinion should be issued.

QUESTION 173
This question-presents independent factual situations an auditor might encounter in conducting an audit. List B represents the report modifications (if any) that would be necessary. Select as the best answer for each item, the action the auditor normally would take. The report modifications in List B may be selected once, more than once, or not at all.
Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.
Item to Be Answered
An entity changes its depreciation method for production equipment from the straight-line to a units-of production method based on hours of utilization. The auditor concurs with the change although it has a material effect on the comparability of the entity's financial statements.
List B
Report Modifications

A. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph without modifying the three standard paragraphs.
B. Describe the circumstances in an explanatory paragraph following the opinion paragraph without modifying the three standard paragraphs.

C. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the opinion paragraph.
D. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the opinion paragraph.
E. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the scope and opinion paragraphs.
F. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the scope and opinion paragraphs.
G. Describe the circumstances within the scope paragraph without adding an explanatory paragraph.
H. Describe the circumstances within the opinion paragraph without adding an explanatory paragraph.
I. Describe the circumstances within the scope and opinion paragraphs without adding an explanatory paragraph.
J. Issue the standard auditor's report without modification.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "B" is the correct modification. Such changes should be described in an explanatory paragraph following the opinion paragraph without modifying the three standard paragraphs.

QUESTION 174
This question-presents independent factual situations an auditor might encounter in conducting an audit. List A represents the types of opinions the auditor ordinarily would issue. Select as the best answer for this item, the action the auditor normally would take. The types of opinions in List A may be selected once, more than once, or not at all.
Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.
Item to Be Answered
An entity is a defendant in a lawsuit alleging infringement of certain patent rights. However, the ultimate outcome of the litigation cannot be reasonably estimated by management. The auditor believes there is a reasonable possibility of a significantly material loss, but the lawsuit is adequately disclosed in the notes to the financial statements.
List A
Types of Options

A. An "except for" qualified opinion.
B. An unqualified opinion.

C. An adverse opinion.
D. A disclaimer of opinion.
E. Either an "except for" qualified opinion or an adverse opinion.
F. Either a disclaimer of opinion or an "except for" qualified opinion.
G. Either an adverse opinion or a disclaimer of opinion.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "B" is the correct opinion. Since the uncertainty is adequately disclosed, an unqualified opinion should be issued.

QUESTION 175
This question-presents independent factual situations an auditor might encounter in conducting an audit. List A represents the types of opinions the auditor ordinarily would issue. Select as the best answer for this item, the action the auditor normally would take. The types of opinions in List A may be selected once, more than once, or not at all.
Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.
Item to Be Answered
An entity discloses in the notes to the financial statements certain lease obligations. The auditor believes that the failure to capitalize these leases is a departure from generally accepted accounting principles.
List A
Types of Options

A. An "except for" qualified opinion.
B. An unqualified opinion.
C. An adverse opinion.
D. A disclaimer of opinion.
E. Either an "except for" qualified opinion or an adverse opinion.
F. Either a disclaimer of opinion or an "except for" qualified opinion.

G. Either an adverse opinion or a disclaimer of opinion.

Correct Answer: E
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "E" is the correct opinion. This is a GAAP departure. Either an "except for" qualified opinion (if the item is material) or an adverse opinion (if the item is very material) should be issued.

QUESTION 176
This question-presents independent factual situations an auditor might encounter in conducting an audit. List B represents the report modifications (if any) that would be necessary. Select as the best answer for each item, the action the auditor normally would take. The report modifications in List B may be selected once, more than once, or not at all.
Assume:
- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.
Item to Be Answered
An entity discloses in the notes to the financial statements certain lease obligations. The auditor believes that the failure to capitalize these leases is a departure from generally accepted accounting principles.
List B
Report Modifications

A. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph without modifying the three standard paragraphs.
B. Describe the circumstances in an explanatory paragraph following the opinion paragraph without modifying the three standard paragraphs.
C. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the opinion paragraph.
D. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the opinion paragraph.
E. Describe the circumstances in an explanatory paragraph preceding the opinion paragraph and modify the scope and opinion paragraphs.
F. Describe the circumstances in an explanatory paragraph following the opinion paragraph and modify the scope and opinion paragraphs.
G. Describe the circumstances within the scope paragraph without adding an explanatory paragraph.
H. Describe the circumstances within the opinion paragraph without adding an explanatory paragraph.
I. Describe the circumstances within the scope and opinion paragraphs without adding an explanatory paragraph.

J. Issue the standard auditor's report without modification.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "C" is the correct modification. The circumstances should be described in an explanatory paragraph preceding the opinion paragraph and the opinion paragraph should be modified.

QUESTION 177
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The nature and extent of a CPA firm's quality controls depend on a number of factors, such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.
Choices "b", "c", and "d" are incorrect, based on the above .

QUESTION 178
Would the following factors ordinarily be considered in planning an audit engagement's personnel requirements?

	Opportunities for on-the-job training	Continuity and periodic rotation of personnel
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. When assigning personnel to an engagement, the firm should consider the following factors in achieving a balance of engagement manpower requirements, personnel skills, and individual development and utilization: 1) engagement size and complexity, 2) personnel availability, 3) special expertise required, 4) timing of the work to be performed, 5) continuity and periodic rotation of personnel, and 6) opportunities for on-the-job training. Choices "b", "c", and "d" are incorrect, based on the above .

QUESTION 179
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 review of the

audit documentation. 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 those charged with governance.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The primary purpose of a second partner review is to ensure that the financial statements are presented in accordance with GAAP.
Choice "b" is incorrect. A search for fraud is typically not part of a second partner review.
Choice "c" is incorrect. The materiality of adjusting entries proposed by the audit staff may be reviewed by a second partner, but they are not the primary focus of such a review. Choice "d" is incorrect. The communication of internal control weaknesses to those charged with governance is not a primary focus of a second partner review.

QUESTION 180
The primary purpose of establishing quality control policies and procedures for deciding whether to accept a new client is to:

A. Enable the CPA firm to attest to the reliability of the client.
B. Satisfy the CPA firm's duty to the public concerning the acceptance of new clients.
C. Minimize the likelihood of association with clients whose management lacks integrity.
D. Anticipate before performing any fieldwork whether an unqualified opinion can be expressed.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity.

Choice "a" is incorrect. Suggesting that there should be procedures to decide whether to accept a client does not imply that a firm vouches for the integrity or reliability of a client.
Choice "b" is incorrect. Suggesting that there should be procedures to decide whether to accept a client does not imply that a firm has a duty to anyone but itself with respect to the acceptance, rejection, or retention of clients. Choice "d" is incorrect. The decision to express an unqualified opinion should be made after the completion of the audit, not upon client acceptance.

QUESTION 181
A CPA firm evaluates its personnel advancement experience to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. This is evidence of the firm's adherence to which of the following prescribed standards:

A. Professional ethics.
B. Supervision and review.
C. Accounting and review services.
D. Quality control.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. The AICPA's Statements on Quality Control Standards assert that professional development policies and procedures should be established by the firm in order to provide reasonable assurance that personnel will have the knowledge required to perform their work and progress within the firm.
Choice "a" is incorrect. The auditors' responsibility is to the public and is defined in the "AICPA Code of Professional Conduct," which includes a set of mandatory rules and which derives its authority from the bylaws of the AICPA. Choice "b" is incorrect. Supervision and review are part of GAAS fieldwork standards.
Choice "c" is incorrect. Accounting and review services pertain to the unaudited financial statements of a nonpublic company.

QUESTION 182
The primary purpose of establishing quality control policies and procedures for deciding whether to accept new clients is to:

A. Minimize the likelihood of association with clients whose management lacks integrity.
B. Monitor significant deficiencies in the design and operation of the client's internal control.
C. Identify noncompliance with aspects of contractual agreements that affect the financial statements.
D. Provide reasonable assurance that personnel will be adequately trained to fulfill their assigned responsibilities.

Correct Answer: A
Section: Volume A

Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Policies and procedures should be established for deciding whether to accept a new client in order to minimize the likelihood of association with a client whose management lacks integrity.
Choice "b" is incorrect. Policies and procedures established for deciding whether to accept a new client would not aid in monitoring internal control deficiencies. A review of internal control would not occur until after a new client was accepted.
Choice "c" is incorrect. Policies and procedures established for deciding whether to accept a new client would not aid in identifying noncompliance with contractual agreements. Reviewing the terms of contractual agreements would not occur until after a new client was accepted.
Choice "d" is incorrect. Policies and procedures established for deciding whether to accept a new client would not aid in the adequate training of personnel. Personnel management policies would be used to ensure that training needs are met.

QUESTION 183
Jackson & Company, CPAs, plan to audit the financial statements of Perigee Technologies, an issuer as defined under the Sarbanes-Oxley Act of 2002. Which of the following situations would impair Jackson's independence?

A. Provision of personal tax services to Johnson, the accounts payable manager of Perigee.
B. Preparation of Perigee's routine annual tax return, where Jackson's fee will be calculated as a percentage of the tax refund obtained.
C. An audit of Perigee's internal control is performed contemporaneously with the annual financial statement audit.
D. Discovering that Lowe, the chief financial officer of Perigee, started his accounting career ten years earlier as a staff accountant for Jackson & Company, and continues to maintain ties with current partners at the firm.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The provision of services involving contingent fee arrangements impairs the auditor's independence.
Choice "a" is incorrect. Personal tax services provided to employees do not impair the auditor's independence; however, personal tax services provided to corporate officers or their families would impair independence.
Choice "c" is incorrect. Independence is not impaired by the performance of an audit of Perigee's internal control; in fact, such services are required by PCAOB Auditing Standard No. 5 (covered in a later class). Choice "d" is incorrect. The prohibition against auditing companies whose corporate officers worked for the auditing firm only applies if those officers worked on the audit during the preceding year.

QUESTION 184

Which of the following are true regarding communication requirements an auditor must follow when providing tax services to an audit client who is an issuer under the Sarbanes-Oxley Act of 2002?
I. The auditor must communicate to the audit committee, in writing, regarding the proposed tax services and related fees.
II. The auditor must communicate to the audit committee, in writing, when the proposed tax services involve contingent fee arrangements.
III. The auditor must discuss with the audit committee the potential effects of the proposed tax services on the firm's independence.

A. I and II only.
B. I, II, and III.
C. I and III only.
D. II and III only.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. The auditor must communicate to the audit committee, in writing, regarding the proposed tax services and related fees, and must discuss with the audit committee the potential effects of the proposed tax services on the firm's independence. Tax services related to contingent fee arrangements, confidential tax transactions, and certain aggressive tax transactions are expressly prohibited. Choices "a", "b", and "d" are incorrect, based on the above .

QUESTION 185
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 .
D. Restrict use of the report to the party who designed the form.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. An auditor should not sign a preprinted report form that includes statements that are inconsistent with the auditor's responsibility. Instead, the form should be revised or a separate, more accurate report should be attached.
Choice "a" is incorrect. Provided the form can be revised or a separate report can be attached, there is no need to withdraw from the engagement.
Choice "c" is incorrect. Qualified opinions relate to departures from GAAP and/or scope limitations, neither of which is the case here.
Choice "d" is incorrect. Even if the use of the report is restricted, an auditor should never sign a report including statements that are inconsistent with the auditor's responsibility.

QUESTION 186
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.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. The engagement described is one to express an opinion on a specified element, account, or item of the financial statements. Since Field's profit participation is based on Gold's net income or stockholders' equity, Hardy can accept the engagement only if Hardy also audited the complete financial statements.
Choice "b" is incorrect. If the auditor can express an opinion that the specified elements, accounts, or items are presented fairly on a basis of accounting other than GAAP, then the auditor can accept the engagement.
Choice "c" is incorrect. Hardy's report need not be available for distribution to Gold's other employees.
Usually the distribution of this type of report is restricted to those within the entity and the parties to the contract or agreement. This is necessary because the basis of presentation is determined by reference to a document that would not generally be available to other third parties. Mandatory distribution of an audit report is never required. Choice "d" is incorrect. Field does not need to own a controlling interest in Gold.

QUESTION 187
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.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Piecemeal opinions (opinions on parts of the financial statements, when those parts constitute a major portion of the financial statements) are not appropriate if the auditor has disclaimed an opinion or issued an adverse opinion, because they may overshadow the auditor's opinion on the financial statements taken as a whole. An opinion on specified elements that does not constitute a piecemeal opinion may be expressed, but should not accompany the disclaimer of opinion or the adverse opinion.
Choice "b" is incorrect. The auditor may express an opinion on one financial statement, even if the auditor must issue a disclaimer on the financial statements taken as a whole.
Choice "c" is incorrect. Even with adequate description in the scope paragraph, an opinion on the current asset portion of the balance sheet cannot be included in a disclaimer of opinion, as it might overshadow the disclaimer. Choice "d" is incorrect. It is not appropriate to include an opinion on the current asset portion of the balance sheet in a disclaimer of opinion, as it might overshadow the disclaimer.

QUESTION 188
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 comprehensive basis of accounting used.
C. Include an 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 comprehensive basis of accounting other than GAAP.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. When reporting on financial statements prepared in conformity with a basis of accounting other than GAAP, the auditor should identify in a separate paragraph the basis as a comprehensive basis other than GAAP. Choice "a" is incorrect. The statements would be examined in accordance with GAAS; however, no opinion (or disclaimer) is given regarding this fact.

Choice "b" is incorrect. The auditor should express an opinion on the financial statements' conformity with the comprehensive basis other than GAAP.
Choice "c" is incorrect. The auditor would include a statement indicating that the basis differs from GAAP, but need not quantify the differences among various bases of accounting.

QUESTION 189
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. An independent auditor may express an opinion on one or more specified elements, accounts, or items of a financial statement as a special engagement, not in conjunction with an audit. Choices "b", "c", and "d" are incorrect, per above .

QUESTION 190
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 explanatory 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.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP that are not suitably titled require a qualified opinion with an explanatory paragraph.
Choice "b" is incorrect. The financial statements are not suitably titleD. The auditor does not need any advice from the insurance commission as to how the statements should be titled or as to how to handle the situation. Choice "c" is incorrect. The auditor would not disclaim an opinion unless there is a scope limitation or independence problem. Choice "d" is incorrect. The notes to the financial statements are communications from management, not from the auditor.

QUESTION 191
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:

A. Qualified opinion.
B. Standard three paragraph report with reference to footnote disclosure.
C. Disclaimer of opinion.
D. Special report.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. A "special report" (unqualified) would be issued in an audit of financial statements prepared on an accounting basis prescribed by a regulatory agency solely for filing with that agency.
Special reports are also issued for:

1. Financial statements that are prepared in accordance with a comprehensive basis of accounting other than GAAP.
2. Specified elements, accounts or items of a financial statement.
3. Compliance with contractual or regulatory requirements related to audited financial statements.
4. Financial information presented in prescribed forms, or schedules that require a prescribed form of auditor's report.

Choices "a" and "c" are incorrect. The special report would be unqualified since Green concluded that the financial statements were fairly presented on the prescribed basis.
Choice "b" is incorrect. The wording of the special report varies slightly from the auditor's standard three paragraph report, and includes an additional explanatory paragraph.

QUESTION 192
An auditor's report would be designated a special report when it is issued in connection with:

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.

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. An auditor's report would be designated a special report when it is issued in connection with compliance with aspects of regulatory requirements related to audited financial statements. Choice "a" is incorrect. A "review report" (not a "special report") should be issued in connection with a limited review of interim financial information of a publicly held company.
Choice "c" is incorrect. Special reports are not issued in connection with the application of accounting principles to specified transactions.
Choice "d" is incorrect. An auditor may compile, examine, or apply agreed-upon procedures to limited use prospective financial statements (PFS) such as a financial projection, but this would not constitute a special report.

QUESTION 193
When a CPA reports on audited financial statements prepared on the cash receipts and disbursements basis of accounting, the report should:

A. Explain why this basis of accounting is more useful for the readers of this entity's financial statements than GAAP.
B. Refer to the note in the financial statements that describes management's responsibility for the financial statements.
C. State that the basis of presentation is a comprehensive basis of accounting (OCBOA) other than GAAP.
D. Include a separate explanatory paragraph that discusses the justification for, and the CPA's concurrence with, the departure from GAAP.

Correct Answer: C
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. A report on other comprehensive basis of accounting ("OCBOA") financial statements should include an explanatory paragraph stating the basis, referring to the footnote that describes it, and indicating that it is a nonGAAP basis.
Choice "a" is incorrect. A report on other comprehensive basis of accounting ("OCBOA") financial statements does not include an evaluation of the usefulness of the basis of accounting.
Choice "b" is incorrect. A report on other comprehensive basis of accounting ("OCBOA") financial statements makes reference to the note in the financial statements that describes the accounting basis, not to a note describing management's responsibility.
Choice "d" is incorrect. The separate explanatory paragraph states the basis, refers to the footnote describing it, and indicates that it is a non-GAAP basis. It does not discuss the justification for the non-GAAP basis, nor does the CPA indicate concurrence.

QUESTION 194
Which option best describes the level of assurance provided in the following special reports?

	Reports on other comprehensive basis of accounting ("OCBOA") financial statements	*Reports on specified elements, accounts, or items in a financial statement*	*Reports on compliance with contractual or regulatory requirements related to audited financial statements*	*Reports on financial presentations to comply with contractual agreements or regulatory provisions*
A.	positive	positive	negative	positive
B.	positive	positive	negative	negative
C.	positive	negative	positive	positive
D.	negative	negative	positive	negative

A. Option A

B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Positive assurance is provided in all of the listed reports except "compliance with contractual or regulatory requirements related to audited financial statements." Negative assurance is provided in this report. Choices "b", "c", and "d" are incorrect, based on the above .

QUESTION 195
Which of the following situations would not result in restricted use language being included in an auditor's special report?

A. A report on a specified element in a financial statement, where that element is prepared in accordance with the terms specified in a related contract.
B. A report on a client's compliance with a regulatory requirement, assuming the report is prepared based on a financial statement audit of the complete financial statements.
C. An "OCBOA" report on financial statements prepared in conformity with requirements established by a regulatory agency, assuming that the auditor's report is a matter of public record.
D. A report on an incomplete financial presentation that is prepared in conformity with GAAP, assuming that the presentation and report will be filed with a regulatory agency and included in a document distributed to the general public.

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. A report on an incomplete financial presentation that is otherwise prepared in conformity with GAAP generally would contain restricted use language; however, an exception occurs when the presentation and the report are filed with a regulatory agency and included in a document distributed to the general public.
Choice "a" is incorrect. A report on a specified element in a financial statement, where that element is prepared in accordance with the terms specified in a related contract, would contain restricted use language.
Choice "b" is incorrect. A report on a client's compliance with a regulatory requirement, assuming the report is prepared based on a financial statement audit of

the complete financial statements, would contain restricted use language. Choice "c" is incorrect. An "OCBOA" report on financial statements prepared in conformity with requirements established by a regulatory agency should contain restrictive use language. This is appropriate even though law or regulation may make the auditor's report is a matter of public record.

QUESTION 196
Which of the following is true about management representations obtained during an engagement to review the financial statements of a nonissuer?

A. Written representations from the current management are required for all periods being reported on.
B. Written representations with respect to prior periods should not be provided by the current management if they were not present during those periods.
C. Written representations should be addressed to members of management whom the accountant believes are responsible for and knowledgeable about the matters covered in the representation letter.
D. Written representations need not include information concerning subsequent events.

Correct Answer: A
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "a" is correct. Written representations from the current management are required for all periods being reported on.
Choice "b" is incorrect. Written representations from the current management are required for all periods being reported on, even if the current management was not present during all such periods.
Choice "c" is incorrect. Written representations should be addressed to the accountant. The letter should be signed by members of management whom the accountant believes are responsible for and knowledgeable about the matters covered in the representation letter.
Choice "d" is incorrect. Written representations should include information concerning subsequent events.

QUESTION 197
In reviewing the financial statements of a nonissuer, an accountant is required to modify the standard review 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
Yes	Yes
Yes	No
No	Yes
No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "d" is correct. Modifications are made to the standard review report only when there is a departure from generally accepted accounting principles. Neither an inability to assess risk nor a discovery of internal control deficiencies constitutes a departure from GAAP, and therefore neither would result in a modified review report. Note that assessing the risk of material misstatement due to fraud is a requirement of an audit, not a review. Also, note that testing of internal control is not required in a review of financial statements of a nonissuer. Choices "a", "b", and "c" are incorrect, based on the above .

QUESTION 198
An accountant has compiled the financial statements of a nonissuer but declines to issue a compilation report. This is an example of:

A. An inappropriate reporting decision, because SSARS require that a report be issued whenever an accountant is associated with financial statements.
B. An inappropriate reporting decision, if the accountant is not independent with respect to the nonpublic entity.
C. An appropriate reporting decision, if the compiled financial statements are not expected to be used by a third party.
D. An appropriate reporting decision, as long as the financial statements are prepared in conformity with GAAP.

Correct Answer: C

Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "c" is correct. If the accountant has compiled the financial statements of a nonissuer, and the compiled financial statements are not expected to be used by a third party, the accountant may decline to issue a compilation report.
Choice "a" is incorrect, since SSARS allow the accountant to decline to issue a compilation report when the compiled financial statements are not expected to be used by a third party.
Choice "b" is incorrect, since there is no requirement that the accountant be independent when the accountant declines to issue a compilation report. Note that an accountant who lacks independence is still permitted to compile the financial statements of a nonissuer entity.
Choice "d" is incorrect, since there is no requirement that the financial statements be prepared in conformity with GAAP when the accountant declines to issue a compilation report.

QUESTION 199
An accountant compiles unaudited financial statements that are not expected to be used by a third party. The accountant may decline to issue a compilation report provided:
I. Each page of the financial statements is clearly marked to restrict its use.
II. A written engagement letter is used to document the understanding with the client.III. A written representation letter is obtained from the client's management.

	I	II	III
A.	Yes	No	Yes
B.	Yes	Yes	No
C.	No	No	Yes
D.	No	Yes	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B
Section: Volume A
Explanation

Explanation/Reference:
Section: Volume A

Choice "b" is correct. The accountant may decline to issue a compilation report provided that each page of the financial statements is clearly marked to restrict its use and a written engagement letter is used to document the understanding with the client.
Choice "a" is incorrect, since a written engagement letter is required to document the understanding with the client, and since representation letters are not required in compilation engagements.
Choice "c" is incorrect, since the accountant may decline to issue a compilation report provided that each page of the financial statements is clearly marked to restrict its use and a written engagement letter is used to document the understanding with the client. Representation letters are not required in compilation engagements.
Choice "d" is incorrect, since the accountant may decline to issue a compilation report provided that each page of the financial statements is clearly marked to restrict its use (and a written engagement letter is used to document the understanding with the client).

QUESTION 200
An accountant has compiled the financial statements of a nonissuer in accordance with Statements on Standards for Accounting and Review Services (SSARS). The financial statements are expected to be used by a third party. 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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume B

Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. SSARS does not require that the compilation report be printed on the accountant's letterhead, nor does it require a manual signature. According to SSARS, a compilation report must state that a compilation has been performed, describe what a compilation is, and emphasize that since no audit or review was performed, no assurance is provided. Although a signature is required, it need not be manual. Choices "a", "b", and "c" are incorrect, per the above .

QUESTION 201
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.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. An accountant is required to comply with the provisions of Statements on Standards for Accounting and Review Services when submitting unaudited financial statements.
Submission is defined as: presenting to a client or third parties financial statements the accountant has prepared. An accountant who reproduces client-prepared financial statements has not prepared those statements. Preparation of standard monthly journal entries is a bookkeeping service that also does not involve preparation of financial statements.

QUESTION 202
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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. An accountant with an immaterial direct financial interest in a client is no longer independent with respect to that client. The accountant is precluded from issuing a review report on the financial statements of an entity with respect to which he is not independent. If the accountant is not independent, he may issue a compilation report provided he complies with the compilation standards.
Choice "a" is incorrect. An accountant who is not independent may still be associated with the financial statements; for example, by performing a compilation engagement.
Choice "c" is incorrect. The accountant is precluded from issuing a review report on the financial statements of an entity with respect to which he is not independent. Choice "d" is incorrect. An accountant with any direct financial interest in a client (even an immaterial interest) is no longer independent with respect to that client.

QUESTION 203
Kell engaged March, CPA, to submit to Kell a written personal financial plan containing unaudited personal financial statements. March anticipates omitting certain disclosures required by GAAP because the engagement's sole purpose is to assist Kell in developing a personal financial plan. For March to be exempt from complying with the requirements of SSARS 1, Compilation and Review of Financial Statements, Kell is required to agree that the:

A. Financial statements will not be presented in comparative form with those of the prior period.
B. Omitted disclosures required by GAAP are not material.
C. Financial statements will not be disclosed to a non-CPA financial planner.
D. Financial statements will not be used to obtain credit.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. An accountant may submit a written personal financial plan containing unaudited personal financial statements to a client without complying with requirements of SSARS 1 when both of the following conditions exist:
1) The accountant establishes an understanding with the client that the financial statements will be used solely to assist the client in developing a financial plan and will not be used to obtain credit, and 2) Nothing comes to the accountant's attention during the engagement indicating that the financial statements will be

used to obtain credit.
Choice "a" is incorrect. Comparative balance sheets may be presented.
Choice "b" is incorrect. It does not matter whether the omitted disclosures required by GAAP are material.
Choice "c" is incorrect. The client is not required to agree that the financial statements will not be disclosed to a non-CPA financial planner.

QUESTION 204
When providing limited assurance that the financial statements of a nonissuer 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 programs to determine whether the entity's financial statements are fairly presented.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. In a review engagement, the auditor should possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates. This will provide, through the performance of inquiry and analytical procedures, a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements to be in conformity with generally accepted accounting principles.
Choice "a" is incorrect. Assessing the risk that a material misstatement could occur in a financial statement assertion is an audit procedure, not a review procedure. Choice "b" is incorrect. Confirmation with the entity's attorney is an audit procedure, not a review procedure.
Choice "d" is incorrect. Development of audit programs are part of an audit engagement, not a review procedure.

QUESTION 205
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 nonissuer?

A. Trend analysis.
B. Regression analysis.
C. Ratio analysis.
D. Risk analysis.

Correct Answer: C

Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Ratio analysis is often used to examine relationships between balance sheet accounts.
Choice "a" is incorrect. Trend analysis would be more appropriate for examining income statement accounts.
Choice "b" is incorrect. Regression analysis would not likely be used since twenty to thirty past observations are generally required to reliably make estimates.
Choice "d" is incorrect. Risk analysis would not be used to evaluate relationships between balance sheet accounts.

QUESTION 206
Compiled financial statements should be accompanied by an accountant's report stating 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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Compiled financial statements should be accompanied by a report stating that the financial statements were compiled in accordance with SSARS issued by the AICPA.
Choice "a" is incorrect. An audit, not a compilation, includes assessing the accounting principles used and significant management estimates, as well as evaluating the overall financial statement presentation.
Choice "c" is incorrect. A review report, not a compilation report, includes the phrase, "is substantially less in scope than an audit."
Choice "d" is incorrect. The accountant expresses no such assurance in a compilation engagement; limited assurance (i.e., "...accountant is not aware of...") is expressed in a review engagement.

QUESTION 207
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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. An accountant may issue a review report on one financial statement, such as a balance sheet, and not on other related financial statements, if the scope of the accountant's inquiry and analytical procedures has not been restricted.
Choice "a" is incorrect. The balance sheet need not be presented in a prescribed form of an industry trade association. Choice "c" is incorrect. There is no limitation on the use of a reviewed financial statement.
Choice "d" is incorrect. Specialized accounting principles should be considered by the accountant when performing the review, but need not be disclosed.

QUESTION 208
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 and fraud 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.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements

taken as a whole, the accountant should withdraw from the review engagement and provide no further services with respect to those financial statements. Note that the accountant should also request that management consider the effect of the scheme on the financial statements.
Choice "a" is incorrect. Since Baker believes modification of the standard report is not adequate, a disclaimer is inappropriate. Baker should withdraw from the engagement. Choices "b" and "d" are incorrect. No opinion may be given based on a review engagement.

QUESTION 209
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. Reviewed, No Accountant's Assurance Expressed.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Each page of the financial statements reviewed by the accountant should include a reference such as "See Accountant's Review Report." Choices "a", "b", and "d" are incorrect, based on the above .

QUESTION 210
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 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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. If an auditor believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements, he should withdraw from the review engagement and provide no additional services with respect to the financial statements.
Choice "b" is incorrect. Limiting the use of the report is not an acceptable option for financial statements under review that contain several departures from GAAP.
Choice "c" is incorrect. Issuing a special report is inappropriate for financial statements under review that contain several departures from GAAP.
Choice "d" is incorrect. If modification of the standard review report is not adequate to indicate departures from GAAP, a modified report should not be issueD. Use of the financial statements is irrelevant.

QUESTION 211
Statements on Standards for Accounting and Review Services (SSARS) require an accountant to report when the 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. Prepared, through the use of computer software, financial statements that are in conformity with a comprehensive basis of accounting other than GAAP, and which are expected to be used by a third party.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. SSARS apply when an accountant "submits" financial statements. Submission is defined as presenting financial statements to a client or third party that the accountant has prepared, either manually or through use of computer software. Preparing financial statements that are in conformity with another comprehensive basis of accounting constitutes a submission of financial statements under SSARS. If the financial statements are expected to be used by a third party, SSARS would require the accountant to report.
Choice "a" is incorrect. Typing or reproducing client-prepared financial statements, without modification, as an accommodation to a client does not constitute submission of financial statements because the accountant has not prepared those statements.
Choice "b" is incorrect. Providing a client with a financial statement format does not constitute a submission of financial statements (the accountant is not preparing the financial statements) and therefore, this does not fall within the guidelines of SSARS.
Choice "c" is incorrect. Proposing correcting journal entries does not constitute submission of financial statements because the client will be the one recording the entries.

QUESTION 212
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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. An accountant performing a review should obtain a client representation letter from the owner, manager, or chief executive officer, and, if appropriate, the chief financial officer. Choice "a" is incorrect. A review does not contemplate obtaining an understanding of internal control or assessing control risk.
Choice "c" is incorrect. Confirmation is a substantive audit procedure that is not appropriate for a review engagement.
Choice "d" is incorrect. A search for unrecorded liabilities is an audit procedure that is not appropriate for a review engagement.

QUESTION 213
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*
Yes	No
No	Yes
No	No
Yes	Yes

A. Option A
B. Option B
C. Option C

D. Option D

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. If the accountant concludes that there is reasonable justification to change the engagement, the accountant's review report should not include reference to the original engagement, to any auditing procedures that may have been performed, or to the scope limitation that resulted in the changed engagement. Choices "a", "b", and "d" are incorrect, per above .

QUESTION 214
Which of the following statements should be included in an accountant's standard report based on the compilation of a nonissuer's financial statements?

A. A compilation consists principally of inquiries of company personnel and analytical procedures applied to financial data.
B. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
C. A compilation is not designed to detect material modifications that should be made to the financial statements.
D. A compilation is substantially less in scope than an audit in accordance with generally accepted auditing standards.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. The accountant's compilation report should state that a compilation is limited to presenting in the form of financial statements information that is the representation of management.
Choice "a" is incorrect. A review (not a compilation) consists principally of inquiries of management and analytical procedures applied to financial data.
Choice "c" is incorrect. While a compilation is not designed to detect material misstatements in the financial statements, no mention of this limitation is made in the compilation report. Choice "d" is incorrect. The review report states that a review is substantially less in scope than an audit in accordance with GAAS.

QUESTION 215
Miller, CPA, is engaged to compile the financial statements of Web Co., a nonissuer, 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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. If financial statements have been compiled on a basis other than GAAP, and the client makes no disclosures in the financial statements to that effect, the accountant should disclose the basis of accounting in the accountant's compilation report.
Choice "b" is incorrect. Under the circumstances, the accountant need only make reference to the other basis of accounting used to compile the financial statements; special labeling of the financial statements is not required. Choice "c" is incorrect. A special report is not warranted in the circumstances. Choice "d" is incorrect. It is not necessary to withdraw from the engagement.

QUESTION 216
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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. If substantially all disclosures required by GAAP are omitted from compiled financial statements, the accountant's compilation report should state that the financial statements are not designed for those who are not informed about such matters.
Choice "b" is incorrect. Omission of substantially all disclosures is not a comprehensive basis of accounting other than GAAP.

Choice "c" is incorrect. If the disclosure is made, the compilation is prepared in accordance with SSARS.
Choice "d" is incorrect. Omission of substantially all disclosures does not make these special-purpose financial statements.

QUESTION 217
North Co., a privately-held entity, asked its tax accountant, King, a CPA in public practice, to prepare North's interim financial statements on King's microcomputer when King prepared North's quarterly tax return. King should not submit these financial statements to North unless, as a minimum, King complies with the provisions of:

A. Statements on Standards for Accounting and Review Services.
B. Statements on Standards for Unaudited Financial Services.
C. Statements on Standards for Consulting Services.
D. Statements on Standards for Attestation Engagements.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. An accountant should not submit unaudited financial statements unless the auditor complies with the provisions applicable to a compilation engagement (under SSARS). Choices "b", "c", and "d" are incorrect, per above .

QUESTION 218
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
No	No
Yes	Yes
Yes	No
No	Yes

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. When an auditor is requested to change the engagement from an audit to a compilation, the auditor must consider the effort needed to complete the audit, the cost of completing the audit, and the reasons for the client's request. If the audit is substantially complete or an insignificant effort is needed to complete the audit, the auditor should consider the propriety of agreeing to the request.
In addition, if the reason for the request is to limit the scope of the auditor's examination, the auditor must consider whether the information affected by the scope limitation is incorrect, incomplete, or otherwise unsatisfactory. A change in circumstance (e.g., an audit is no longer necessary) or a misunderstanding as to the nature of an audit would, on the other hand, be considered a reasonable basis for the change. Choices "a", "c", and "d" are incorrect, based on the above .

QUESTION 219
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.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. An accountant may issue a review report on one financial statement, such as a balance sheet, as long as the scope of the inquiry and analytical procedures has not been restricted.

Choice "a" is incorrect. There is no requirement that Smith compile the other financial statements.
Choice "b" is incorrect. An accountant can still review only the balance sheet, even if the review discloses material departures from GAAP. These departures should be reflected in the accountant's report, however. Choice "d" is incorrect. Smith may audit only the balance sheet even if Cone is a continuing client.

QUESTION 220
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Knowledge of the accounting principles and practices of the industry is required in order to perform a compilation or review engagement; however, there is no requirement that such knowledge be obtained prior to accepting such an engagement.
Choices "a", "b", and "c" are incorrect, per above.

QUESTION 221
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Analytical procedures are part of a review engagement, but not necessary for a compilation engagement. Choices "a", "b", and "c" are incorrect, per above s.

QUESTION 222
Which of the following procedures most likely would not be included in a review engagement of a nonissuer?

A. Obtaining a management representation letter.
B. Considering whether the financial statements conform with GAAP.
C. Assessing control risk.
D. Inquiring about subsequent events.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. An accountant is not required to assess control risk as part of a review engagement. Assessment of control risk would be appropriate for an audit engagement.
Choice "a" is incorrect. Obtaining a management representation letter is an appropriate review procedure.
Choice "b" is incorrect. Considering whether the financial statements are in accordance with GAAP is an appropriate review procedure. Choice "d" is incorrect. Inquiring of management regarding subsequent events is an appropriate review procedure.

QUESTION 223
Compiled financial statements should be accompanied by a report stating that:

A. A compilation is substantially less in scope than a review or an audit in accordance with generally accepted auditing standards.
B. The accountant does not express an opinion but expresses only limited assurance on the compiled financial statements.
C. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
D. The accountant has compiled the financial statements in accordance with standards established by the Auditing Standards Board.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. The accountant's report includes a statement that the compilation is limited to presenting in the form of financial statements information that is the representation of management.
Choice "a" is incorrect. The report must state that the financial statements have not been audited or reviewed, but does not compare the scope of a compilation to the scope of a review or an audit.
Choice "b" is incorrect. The accountant expresses no assurance in a compilation engagement; limited assurance is expressed in a review engagement.
Choice "d" is incorrect. The financial statements are compiled in accordance with SSARS issued by the AICPA, rather than "standards established by the Auditing Standards Board."

QUESTION 224
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.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. An accountant may issue a compilation report for a client's financial statements that omit all required GAAP disclosures, provided the omission is not intended to mislead financial statement users and the omission is clearly indicated in the accountant's report.
Choices "a", "b", and "d" are incorrect, per above .

QUESTION 225
An accountant's standard report on a review of the financial statements of a nonissuer should state that the accountant:

A. Does not express an opinion or any form of limited assurance on the financial statements.
B. Is not aware of any material modifications that should be made to the financial statements for them to conform with GAAP.
C. Obtained reasonable assurance about whether the financial statements are free of material misstatement.
D. Examined evidence, on a test basis, supporting the amounts and disclosures in the financial statements.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. The accountant's report on a review engagement should state that the accountant is not aware of any material modifications that should be made to the financial statements for them to conform with GAAP.
Choice "a" is incorrect. An accountant expresses limited assurance in a review engagement.

Choice "c" is incorrect. "Reasonable assurance about whether the financial statements are free of material misstatement" is required for audit engagements, but is not necessary for review engagements. Choice "d" is incorrect. Examining evidence on a test basis is required for an audit engagement; procedures for a review engagement are limited to inquiry and analytical procedures.

QUESTION 226
An accountant has been asked to issue a review report on the balance sheet of a nonissuer 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 a violation of the ethical standards of the profession.
B. Because compliance with this request would result in an incomplete review.
C. If the review of the balance sheet discloses material departures from GAAP.
D. If the scope of the inquiry and analytical procedures has been restricted.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. An accountant may issue a review report on one financial statement, such as a balance sheet, as long as the scope of the inquiry and analytical procedures has not been restricted. Choice "a" is incorrect. Compliance with this request would not violate any ethical standards of the profession.
Choice "b" is incorrect. Compliance with this request would not necessarily result in an incomplete review.
Choice "c" is incorrect. An accountant can still review only the balance sheet, even if the review discloses material departures from GAAP. However, these departures should be reflected in the accountant's report.

QUESTION 227
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. Restrict the use of the accountant's report.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:

Section: Volume B

Choice "b" is correct. As part of the inquiries made during a review engagement, an accountant would ask about actions taken at board of directors' meetings that affect the financial statements.
Choice "a" is incorrect. Certain procedures, such as confirmation of receivables and observation of inventory, are customarily performed in an audit but not in compilation or review engagements.
Choice "c" is incorrect. A review engagement does not include obtaining an understanding of the client's internal control. Choice "d" is incorrect. The accountant would not normally restrict the use of the review report.

QUESTION 228
During an engagement to review the financial statements of a nonissuer an accountant becomes aware of a material departure from GAAP. If the accountant decides to modify the standard review report because management will not revise the financial statements, the accountant should:

A. Express negative assurance on the accounting principles that do not conform with GAAP.
B. Disclose the departure from GAAP in a separate paragraph of the report.
C. Issue an adverse or an "except for" qualified opinion, depending on materiality.
D. Express positive assurance on the accounting principles that conform with GAAP.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. If the accountant concludes that modification of the standard report is appropriate, the departure should be disclosed in a separate paragraph of the report. Choice "a" is incorrect. An accountant would not express negative assurance on the accounting principles that do not conform with GAAP in a review engagement.
Choice "c" is incorrect. An accountant would not issue an opinion in a review engagement.
Choice "d" is incorrect. An accountant would not express positive assurance (i.e., an opinion) on the accounting principles that conform with GAAP in a review engagement.

QUESTION 229
Which of the following representations does an accountant make implicitly when issuing the standard report for the compilation of a nonissuer's financial statements?

A. The accountant is independent with respect to the entity.
B. The financial statements have not been audited.

C. A compilation consists principally of inquiries and analytical procedures.
D. The accountant does not express any assurance on the financial statements.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. If the accountant is not independent, he should specifically disclose the lack of independence. Otherwise, independence is implied.
Choice "b" is incorrect. The report accompanying compiled financial statements explicitly states that the financial statements have not been audited.
Choice "c" is incorrect. Inquiry and analytical procedures are not performed in a compilation engagement.
Choice "d" is incorrect. The report accompanying compiled financial statements explicitly states that the accountant provides no assurance on the financial statements.

QUESTION 230
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.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. An accountant can prepare a working trial balance and prepare standard monthly journal entries without being required to issue a compilation or review report under the SSARS as long as the performance of these services does not carry forward into the submission of financial statements.
Choice "a" is incorrect. Monthly journal entries can be prepared. Choice "b" is incorrect. A working trial balance can be prepared.

Choice "d" is incorrect. Both of these services can be rendered as long as they do not carry forward into the preparation of financial statements.

QUESTION 231
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 evidential matter.
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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. When reviewing a nonissuer's financial statements, an accountant ordinarily makes inquiries concerning the entity's procedures for recording and summarizing transactions.
Choices "a", "c", and "d" are incorrect. The following audit procedures generally are not performed in a review engagement:
A. Tests of the accounting records.
C. Tests of management's assertions regarding continued existence.
D. Inquiries of the entity's attorney concerning contingent liabilities.

QUESTION 232
When compiling the financial statements of a nonissuer, an accountant should:

A. Review agreements with financial institutions for restrictions on cash balances.
B. Understand the accounting principles and practices of the entity's industry.
C. Inquire of key personnel concerning related parties and subsequent events.
D. Perform ratio analyses of the financial data of comparable prior periods.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. When compiling the financial statements of a nonissuer, an accountant should understand the accounting principles and practices of the entity's industry.
Choice "a" is incorrect. Reviewing agreements with financial institutions for restrictions is generally performed during an audit.
Choice "c" is incorrect. Inquiring of key personnel concerning related parties and subsequent events is not required in a compilation.
Choice "d" is incorrect. Performing ratio analyses of the financial data of comparable prior periods is generally performed for review engagements and audits, not compilations.

QUESTION 233
Jones Retailing, a nonissuer, has asked Winters, CPA, to compile financial statements that omit substantially all disclosures required by generally accepted accounting principles. Winters may compile such financial statements provided the:

A. Reason for omitting the disclosures is explained in the engagement letter and acknowledged in the management representation letter.
B. Financial statements are prepared on a comprehensive basis of accounting other than generally accepted accounting principles.
C. Use of the financial statements is restricted to internal use only.
D. Omission is not undertaken to mislead the users of the financial statements and is properly disclosed in the accountant's report.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. An accountant may compile FS that omit substantially all disclosures required by GAAP provided the omission is not undertaken to mislead the users of the FS and is properly disclosed in the accountant's report as an additional third paragraph.
Choice "a" is incorrect. There is no requirement that the reason for omitting the disclosures be explained in an engagement letter or acknowledged in the management representation letter (which, by the way, is not required for compilation engagements).
Choice "b" is incorrect. Financial statements compiled in accordance with GAAP may omit substantially all required disclosures.
Choice "c" is incorrect. Substantially all disclosures required by GAAP may be omitted in a compilation without restricting use to internal parties.

QUESTION 234
Which of the following procedures is usually performed by the accountant in a review engagement of a nonissuer?

A. Sending a letter of inquiry to the entity's lawyer.
B. Comparing the financial statements with statements for comparable prior periods.
C. Confirming a significant percentage of receivables by direct communication with debtors.
D. Communicating significant deficiencies discovered during the study of the internal control structure.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Comparing the financial statements with statements for comparable prior periods (analytical procedures) is a procedure that is usually performed by the accountant in a review engagement of a nonissuer.
Choice "a" is incorrect. Sending a letter of inquiry to the entity's lawyer is a procedure generally performed only in an audit of an entity's financial statements.
Choice "c" is incorrect. Confirming a significant percentage of receivables by direct communication with debtors is a procedure generally performed only in an audit of an entity's financial statements.
Choice "d" is incorrect. Communicating significant deficiencies discovered during the study of the internal control structure is a procedure generally performed only in an audit of an entity's financial statements.
(The internal control structure is generally not evaluated in a review engagement.)

QUESTION 235
Which of the following procedures is more likely to be performed in a review engagement of a nonissuer than in a compilation engagement?

A. Gaining an understanding of the entity's business transactions.
B. Making a preliminary assessment of control risk.
C. Obtaining a representation letter from the chief executive officer.
D. Assisting the entity in adjusting the accounting records.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Obtaining a representation letter from the CEO is more likely to be performed in a review engagement of a nonissuer (where obtaining the letter is required) than in a compilation engagement. Choice "a" is incorrect. Gaining an understanding of the entity's business transactions would be performed in both a compilation and a review engagement.
Choice "b" is incorrect. Making a preliminary assessment of control risk would only be performed in an audit, not in a compilation or review.
Choice "d" is incorrect. Assisting the entity in adjusting (compiling) the accounting records is more likely to be performed in a compilation engagement than in a review.

QUESTION 236
Statements on Standards for Accounting and Review Services establish standards and procedures for which of the following engagements?

A. Proposing adjustments to the books of account for a partnership.
B. Reviewing interim financial data required to be filed with the SEC.
C. Preparing standard monthly journal entries.
D. Compiling an individual's personal financial statement to be used to obtain a mortgage.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Statements on Standards for Accounting and Review Services (SSARS) establish standards and procedures for an engagement to compile an individual's personal financial statements to be used to obtain a mortgage. Choice "a" is incorrect. Proposing adjustments to the books of account for a partnership is an engagement that does not pertain to SSARS, as it falls short of submitting financial statements.
Choice "b" is incorrect. Reviewing interim financial data required to be filed with the SEC is covered under PCAOB standards. SSARS only applies to nonissuers.
Choice "c" is incorrect. Preparing standard monthly journal entries is not covered by SSARS, as it falls short of submitting financial statements.

QUESTION 237
When compiling a nonissuer's financial statements, an accountant would be least likely to:

A. Perform analytical procedures designed to identify relationships that appear to be unusual.
B. Read the compiled financial statements and consider whether they appear to include adequate disclosure.
C. Omit substantially all of the disclosures required by generally accepted accounting principles.
D. Issue a compilation report on one or more, but not all, of the basic financial statements.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. During a compilation of a nonissuer's financial statements, an accountant generally would not perform analytical procedures. (Analytical

procedures are required in a review.) Choice "b" is incorrect. The accountant compiling financial statements generally would read those statements to consider whether they appear to include adequate disclosure.
Choice "c" is incorrect. The accountant compiling financial statements might omit substantially all of the disclosures required by GAAP.
Choice "d" is incorrect. The accountant compiling financial statements might issue a compilation report on one or more, but not all, of the basic financial statements.

QUESTION 238
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 the internal control structure.
D. Performing cutoff tests on sales and purchases transactions.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. A review engagement is based on inquiry and analytical procedures. Inquiring about related party transactions is a procedure which would most likely be included in a review engagement of a nonpublic entity. Choice "a" is incorrect. Preparing a bank transfer schedule pertains to an audit engagement.
Choice "c" is incorrect. Assessing the internal control structure pertains to an audit engagement.
Choice "d" is incorrect. Performing cutoff tests on sales and purchases transactions pertains to an audit engagement.

QUESTION 239
Baker, CPA, was engaged to review the financial statements of Hall Company, a nonissuer. Evidence came to Baker's attention that indicated substantial doubt as to Hall's ability to continue as a going concern. The principal conditions and events that caused the substantial doubt have been fully disclosed in the notes to Hall's financial statements. Which of the following statements best describes Baker's reporting responsibility concerning this matter?

A. Baker is not required to modify the accountant's review report.
B. Baker is not permitted to modify the accountant's review report.
C. Baker should issue an accountant's compilation report instead of a review report.
D. Baker should express a qualified opinion in the accountant's review report.

Correct Answer: A

Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. Since the principal conditions and events that caused the substantial doubt as to the company's ability to continue as a going concern have been fully disclosed in the notes to Hall's financial statements, Baker is not required to modify the accountant's review report. Baker may, however, choose to emphasize this issue in the report.
Choice "b" is incorrect. The auditor is permitted to modify his review report as he/she feels appropriate in the circumstances.
Choice "c" is incorrect. Baker did not perform a compilation; therefore, a compilation report would not be appropriate.
Choice "d" is incorrect. Since the facts have been fully disclosed in the notes to the financial statements, no modification to the review report is required. Also, an opinion is never expressed based on a review engagement.

QUESTION 240
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.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. The accounting and review services committee is the authoritative body designated to promulgate standards concerning an accountant's association with unaudited financial statements of a nonissuer (i.e., an entity that is not required to file financial statements with an agency regulating the issuance of the entity's securities). Choice "a" is incorrect. The Financial Accounting Standards Board (FASB) is responsible for GAAP standards.
Choice "b" is incorrect. The General Accounting Office (GAO) is responsible for audit standards under the federal "Single Audit Act." Choice "d" is incorrect. The Auditing Standards Board (ASB) is responsible for auditing standards under GAAS.

QUESTION 241
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, 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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. 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, the accountant generally should issue the report that is appropriate for the highest level of service rendered.
Choices "a", "c", and "d" are incorrect. The report should be appropriate for the highest level of service rendered.

QUESTION 242
An accountant who reviews the financial statements of a nonissuer should issue a report stating that a review:

A. Is substantially less in scope than an audit.
B. Provides negative assurance that the internal control structure is functioning as designed.
C. Provides only limited assurance that the financial statements are fairly presented.
D. Is substantially more in scope than a compilation.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. 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. (This is why you have to "memorize" the key phrases in the review and compilation reports.)
Choice "b" is incorrect. Internal control inquiries are not part of a review, and therefore assurances related to internal control are inappropriate.
Choice "c" is incorrect. A review does provide limited assurance as to GAAP, but this is not the appropriate wording for the report. Choice "d" is incorrect. Review

report language compares a review with an audit, not with a compilation.

QUESTION 243
Before performing a review of a nonissuer's financial statements, an accountant should:

A. Complete a series of inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions.
B. Apply analytical procedures to provide limited assurance that no material modifications should be made to the financial statements.
C. Obtain a sufficient level of knowledge of the accounting principles and practices of the industry in which the entity operates.
D. Inquire whether management has omitted substantially all of the disclosures required by generally accepted accounting principles.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Before performing a review of a nonissuer's financial statements, an accountant should obtain a sufficient level of knowledge of the accounting principles and practices of the industry in which the entity operates. Choices "a", "b", and "d" are incorrect. These are appropriate steps performed during the review, not prior to it.

QUESTION 244
Which of the following is not true about documentation requirements related to a review of a nonissuer's financial statements?

A. Written documentation from a compilation engagement may be used to provide support for the review report.
B. A management representation letter should be included in the documentation files.
C. The auditor must document evidence obtained about the operating effectiveness of controls.
D. Documentation should include the results of analytical procedures.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. The accountant is not required to evaluate control risk or test the operating effectiveness of controls in a review of a nonpublic entity's

financial statements.
Choice "a" is incorrect. Written documentation from other types of engagements may be used to provide support for the review report.
Choice "b" is incorrect. A management representation letter should be obtained in review engagements, and a copy should be included in the documentation files.
Choice "d" is incorrect. Documentation should include the results of analytical procedures (i.e., procedures performed, expectations and how they were developed, results of comparison to recorded amounts, and procedures performed with respect to significant differences).

QUESTION 245
An accountant performing a compilation or review of the financial statements of a nonissuer should:

A. Be able to justify departures from SSARS.
B. Never depart from SSARS guidelines.
C. Exercise professional judgment in applying SSARS, since they are considered recommendations as opposed to standards.
D. Not depart from Statements on Auditing Standards.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. An accountant should be able to justify departures from SSARS.
Choice "b" is incorrect. An accountant may occasionally depart from SSARS guidelines, but should be prepared to justify such departures.
Choice "c" is incorrect. While it is true that an accountant should exercise professional judgment in applying SSARS, it is not true that SSARS are considered recommendations. SSARS are professional standards, which the accountant should generally follow.
Choice "d" is incorrect. Statements on Auditing Standards do not apply to compilations or reviews of the financial statements of a nonissuer.

QUESTION 246
When performing an engagement to review a nonissuer's financial statements, an accountant most likely would:

A. Obtain an understanding of the entity's internal control.
B. Limit the distribution of the accountant's report.
C. Confirm a sample of significant accounts receivable balances.
D. Ask about actions taken at board of directors' meetings.

Correct Answer: D
Section: Volume B

Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. A review is based on inquiry and analytical procedures. The accountant should inquire about actions authorized by the stockholders, the board of directors, or other management groups.
Choice "a" is incorrect. The accountant is not required to obtain an understanding of internal control in a review engagement under SSARS. An understanding would be required in an audit or in a review of the interim financial statements of a public entity, conducted under auditing (PCAOB) standards.
Choice "b" is incorrect. Distribution of a review report is not limited; however, each page of the financial statements should be marked, "See Accountant's Review Report."
Choice "c" is incorrect. Confirmation is an auditing procedure used to corroborate stated account balances. A review is based on inquiry and analytical procedures, and would not include confirmation of balances.

QUESTION 247
Which of the following should be the first step in reviewing the financial statements of a nonissuer?

A. Comparing the financial statements with statements for comparable prior periods and with anticipated results.
B. Completing a series of inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions.
C. Obtaining a general understanding of the entity's organization, its operating characteristics, and its products or services.
D. Applying analytical procedures designed to identify relationships and individual items that appear to be unusual.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. In reviewing the financial statements of a nonissuer, the accountant's first step would be to obtain a general understanding of the entity's organization, its operating characteristics, and its products or services.
Choices "a", "b", and "d" are incorrect. Inquiry and analytical review procedures would be performed after a general understanding of the client is obtained. This understanding will help the accountant more appropriately tailor the inquiry and analytical review procedures to the specific client engagement.

QUESTION 248
An accountant has been asked to issue a review report on the balance sheet of a nonissuer without reporting on the related statements of income, retained earnings, and cash flows. The accountant may issue the requested review report only if:

A. The balance sheet is not to be used to obtain credit or distributed to the entity's creditors.

B. The balance sheet is part of a comprehensive personal financial plan developed to assist the entity.
C. There have been no material changes during the year in the entity's accounting principles.
D. The scope of the accountant's inquiry and analytical procedures has not been restricted.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. A review engagement may involve reporting on only one financial statement, provided the scope of the engagement was not limited.
Choice "a" is incorrect. A review engagement may involve reporting on only one financial statement, provided the scope of the engagement was not limited. There are no requirements regarding the use of the balance sheet.
Choice "b" is incorrect. A review engagement may involve reporting on only one financial statement, provided the scope of the engagement was not limited. There is no requirement that the balance sheet be part of a comprehensive personal financial plan.
Choice "c" is incorrect. A review engagement may involve reporting on only one financial statement, provided the scope of the engagement was not limited. There is no requirement that accounting principles remain consistent during the year.

QUESTION 249
An accountant is asked to issue a review report on the balance sheet, but not on other related statements. The scope of the inquiry and analytical procedures has not been restricted, but the client failed to provide a representation letter.
Which of the following should the accountant issue under these circumstances?

A. Review report with a qualification.
B. Review report with a disclaimer.
C. Review report and footnote exceptions.
D. Compilation report with the client's consent.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. A management representation letter is required for a review engagement. If no representation letter is provided, the review is incomplete and a no review report may be issued. Since there is no requirement for a representation letter in relation to a compilation engagement, the engagement may be changed to a compilation engagement (with the client's consent). Choices "a", "b", and "c" are incorrect. Incomplete reviews do not result in any sort of modification to the review report; rather, no review report may be issued.

QUESTION 250
Which of the following procedures is usually the first step in reviewing the financial statements of a nonissuer?

A. Make preliminary judgments about risk and materiality to determine the scope and nature of the procedures to be performed.
B. Obtain a general understanding of the entity's organization, its operating characteristics, and its products or services.
C. Assess the risk of material misstatement arising from fraudulent financial reporting and the misappropriation of assets.
D. Perform a preliminary assessment of the operating efficiency of the entity's internal control activities.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. In reviewing the financial statements of a nonpublic entity, one of the first steps would be to obtain sufficient knowledge of the entity's business, including its organization, operating characteristics, and products or services.
Choice "a" is incorrect. In an audit, preliminary judgments about risk and materiality are used to determine the scope and nature of procedures to be performed. A review is substantially less in scope than an audit and consists principally of inquiries and analytical procedures.
Choice "c" is incorrect. In an audit, the risk of material misstatement arising from fraud must be assessed in order to determine the scope and nature of procedures to be performed. A review is substantially less in scope than an audit and consists principally of inquiries and analytical procedures. While inquiries would be made about fraud, a formal fraud risk assessment is not required. Choice "d" is incorrect. In a review of a nonissuer's financial statements, no assessment or testing of internal control is required.

QUESTION 251
An accountant's standard report issued after compiling the financial statements of a nonissuer should state that:

A. I am not aware of any material modifications that should be made to the accompanying financial statements.
B. A compilation consists principally of inquiries of company personnel and analytical procedures.
C. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
D. A compilation is substantially less in scope than an audit in accordance with GAAS, the objective of which is the expression of an opinion.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. An accountant's standard report issued after compiling the financial statements of a nonissuer should state that "a compilation is limited to presenting in the form of financial statements information that is the representation of management."
Choice "a" is incorrect. A review report (and not a compilation report) states that, "I am not aware of any material modifications that should be made to the accompanying financial statements."
Choice "b" is incorrect. A review report (and not a compilation report) states that a review "consists principally of inquiries of company personnel and analytical procedures."
Choice "d" is incorrect. A review report (and not a compilation report) states that a review "is substantially less in scope than an audit in accordance with GAAS, the objective of which is the expression of an opinion."

QUESTION 252
Which of the following would be used on a review engagement?

A. Examination of board minutes.
B. Confirmation of cash and accounts receivable.
C. Comparison of current-year to prior-year account balances.
D. Recalculation of depreciation expense.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. A review consists of inquiries and analytical procedures. Comparison of current year and prior year account balances is an analytical procedure that would often be performed as part of a review. Choice "a" is incorrect. Examining board minutes is an audit procedure that would not typically be performed in a review.
Choice "b" is incorrect. Confirmations of cash and accounts receivable are audit procedures that would not typically be performed in a review. Choice "d" is incorrect. Recalculation of expenses is an audit procedure that would not typically be performed in a review.

QUESTION 253
Which of the following statements is true regarding an accountant's consideration of fraud/illegal acts in compilation and review engagements?

A. The accountant is not required to perform procedures designed to detect material misstatements due to fraud or illegal acts.
B. The accountant must inform an appropriate level of management of all instances of fraud or illegal acts.

C. The accountant must report only definite instances of fraud or an illegal act, but need not report information indicating that fraud or an illegal act may have occurred.
D. Information indicating that fraud or an illegal act may have occurred should be reported in writing to an appropriate level of management.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. The accountant is not required to specifically assess fraud risk or to perform procedures designed to detect material misstatements due to fraud or illegal acts.
Choice "b" is incorrect. Inconsequential instance of fraud or illegal acts need not be reported to management.
Choice "c" is incorrect. The accountant should report to an appropriate level of management any evidence or information that comes to his or her attention indicating that fraud or an illegal act may have occurred.
Choice "d" is incorrect. Information indicating that fraud or an illegal act may have occurred should be reported to an appropriate level of management, but it need not be in writing. Oral communication to management should be documented.

QUESTION 254
An accountant had begun to audit the financial statements of a nonissuer. Which of the following circumstances most likely would be considered a reasonable basis for agreeing to the entity's request to change the engagement to a compilation?

A. The entity's management does not provide the accountant with a signed representation letter.
B. The accountant is prohibited from corresponding with the entity's legal counsel.
C. The entity's principal creditors no longer require the entity to furnish audited financial statements.
D. The accountant is prevented from examining the minutes of the board of directors' meetings.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. An audit may be changed to a compilation or review due to a change in client requirements. Since the creditors no longer require audited financial statements, this is a valid reason for requesting a change. Choices "a", "b", and "d" are incorrect. Client-imposed scope limitations, such as refusing to provide a signed representation letter, prohibiting correspondence with legal counsel, or refusing to allow examination of board minutes, are indicative of a lack of cooperation by management. Such limitations would not be a valid basis for changing an engagement from an audit to a compilation.

QUESTION 255
Which of the following statements is correct regarding a review engagement of a nonissuer's financial statements performed in accordance with the Statements on Standards for Accounting and Review Services (SSARS)?

A. An accountant must establish an understanding with the client in an engagement letter.
B. An accountant must obtain an understanding of the client's internal control when performing a review.
C. A review provides an accountant with a basis for expressing limited assurance on the financial statements.
D. A review report contains an accountant's opinion of the financial statements taken as a whole.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. A review report is issued when inquiry and analytical procedures provide a reasonable basis for the expression of limited assurance on the financial statements.
Choice "a" is incorrect. While the accountant is required to establish an understanding with the client, preferably in writing, an engagement letter is not required.
Choice "b" is incorrect. When performing a review under SSARS, the accountant is not required to obtain an understanding of the client's internal control.
Choice "d" is incorrect. A review results in the expression of limited assurance that no material modifications are necessary for the financial statements to be in conformity with generally accepted accounting principles. The limited nature of the work performed during a review does not provide sufficient evidence for an opinion on the financial statements taken as a whole.

QUESTION 256
Which of the following procedures does a CPA normally perform first in a review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS)?

A. Inquiry regarding the client's principles and practices and the method of applying them.
B. Inquiry concerning the effectiveness of the client's system of internal control.
C. Inquiry to identify transactions between related parties and management.
D. Inquiry of the client's professional advisors, including bankers, insurance agents, and consultants.

Correct Answer: A

Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. In performing a review engagement in accordance with SSARS, the accountant should inquire of management regarding the accounting principles and practices used, and the method of applying them.
Choice "b" is incorrect. When performing a review under SSARS, the accountant is not required to make inquiries concerning the client's system of internal control.
Choice "c" is incorrect. The accountant may inquire about the existence of related party transactions, but would likely make a more basic inquiry, about the client's accounting principles and practices, first. Choice "d" is incorrect. In performing a review engagement in accordance with SSARS, the accountant generally directs his/her inquiries to members of management, not to external parties.

QUESTION 257
Which of the following describes how the objective of a review of financial statements differs from the objective of a compilation engagement?

A. The primary objective of a review engagement is to test the completeness of the financial statements prepared, but a compilation tests for reasonableness.
B. The primary objective of a review engagement is to provide positive assurance that the financial statements are fairly presented, but a compilation provides no such assurance.
C. In a review engagement, accountants provide limited assurance, but a compilation expresses no assurance.
D. In a review engagement, accountants provide reasonable or positive assurance that the financial statements are fairly presented, but a compilation provides limited assurance.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. A review provides limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles, whereas a compilation provides no assurance.
Choice "a" is incorrect. A review does not test for completeness, nor does a compilation test for reasonableness. A review provides limited assurance about the financial statements based on inquiry and analytical review procedures, while a compilation provides no assurance and includes no testing for reasonableness.
Choice "b" is incorrect. A review provides limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles, and it is based on inquiry and analytical review procedures. Positive assurance (such as an audit opinion) is only provided when more extensive procedures have been performed.

Choice "d" is incorrect. A review provides limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles, and it is based on inquiry and analytical review procedures. Positive or reasonable assurance (such as an audit opinion) is only provided when more extensive procedures have been performed. A compilation provides no assurance at all.

QUESTION 258
The standard report issued by an accountant after reviewing the financial statements of a nonissuer should state that:

A. A review is limited to presenting in the form of financial statements information that is the representation of management.
B. A review consists of inquiries of company personnel and analytical procedures applied to financial data.
C. The accountant does not express an opinion or any other form of assurance on the financial statements.
D. The accountant did not obtain an understanding of the entity's internal control or assess control risk.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. The standard report issued by an accountant after reviewing the financial statements of a nonissuer states that a review consists of inquiries of company personnel and analytical procedures applied to financial data.
Choice "a" is incorrect. A compilation report uses language similar to this, stating that a compilation is limited to presenting, in the form of financial statements, information that is the representation of management.
Choice "c" is incorrect. A compilation report uses language similar to this, stating that the accountant does not express an opinion or any other form of assurance on the financial statements. A review provides negative assurance.
Choice "d" is incorrect. While it is true that a review of the financial statements of a nonpublic entity does not require the accountant to obtain an understanding of the entity's internal control or assess control risk, the report does not explicitly state this.

QUESTION 259
While auditing the financial statements of a nonissuer, a CPA was requested to change the engagement to a review in accordance with Statements on Standards for Accounting and Review Services (SSARS) because of a scope limitation.
If the CPA believes the client's request is reasonable, the CPA's review report should:
I. Refer to the scope limitation that caused the change.
II. Describe the auditing procedures that have already been applied.

A. I only.
B. II only.
C. Both I and II.

D. Neither I nor II.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. If the CPA believes the client's request is reasonable, he/she must comply with the standards for a review and issue an appropriate report. The report should not refer to the original engagement, to any auditing procedures performed, or to the scope limitation.
Choices "a", "b", and "c" are incorrect, based on the above .

QUESTION 260
When unaudited financial statements of a nonissuer are presented in comparative form with audited financial statements in the subsequent year, the unaudited financial statements should be clearly marked to indicate their status and:
I. The report on the unaudited financial statements should be reissued.
II. The report on the audited financial statements should include a separate paragraph describing the responsibility assumed for the unaudited financial statements.

A. I only.
B. II only.
C. Both I and II.
D. Either I or II.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. When audited financial statements are presented in comparative form with unaudited financial statements from a prior year, the auditor should either reissue his or her report on the unaudited statements or include a separate paragraph in the current year report describing the responsibility assumed for the unaudited statements. Choices "a", "b", and "c" are incorrect, per above .

QUESTION 261
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 auditors report
A.	Yes	No	No
B.	Yes	No	Yes
C.	No	Yes	Yes
D.	No	Yes	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. When unaudited financial statements (generally the first quarter of the following year in an annual report) are presented in comparative form with audited financial statements in documents filed with the SEC, such statements should be clearly marked as "unaudited," but should not be referred to in the auditor's report. The statements need not be withheld until audited. Choices "b", "c", and "d" are incorrect, based on above.

QUESTION 262
Clark, CPA, compiled and properly reported on the financial statements of Green Co., a nonissuer, for the year ended March 31, 20X1. 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, 20X2, and to include all GAAP disclosures for the 20X2 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 20X1 statements are not comparable to the 20X2 statements that include the

GAAP disclosures.

B. Clark may report on the comparative financial statements provided the 20X1 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 20X1 statements that do not include the GAAP disclosures.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. Compiled financial statements that omit substantially all the disclosures required by GAAP are not comparable to financial statements that do include required GAAP disclosures.
Accordingly, the 20X1 statements are not comparable to the 20X2 statements and Clark cannot report on them.
Choice "b" is incorrect. The lack of material misstatements does not alter the fact that the statements are not comparable and therefore Clark may not report on them.
Choice "c" is incorrect. Compiled financial statements that omit substantially all of the disclosures required by GAAP are not comparable to financial statements that include such disclosures. Accordingly, Clark may not report on the comparative financial statements, even if an explanatory paragraph is added.
Choice "d" is incorrect. Updating the auditor's report does not change the fact that the financial statements for the two periods are not comparable.

QUESTION 263
Silver, CPA, has been hired by Andrews Co., a publicly held company, to conduct a review of its interim financial information. While performing review procedures, Silver becomes aware of a significant change in the control activities at one of Andrew's branch locations. Which of the following might Silver consider performing in response to this situation?

A. Making additional inquiries, such as whether management has monitored the changes and considered whether they were operating as intended.
B. Employing analytical procedures with a less precise expectation.
C. Both "a" and "b" above.
D. Neither "a" nor "b" above.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:

Section: Volume B

Choice "a" is correct. An accountant's knowledge of an entity's business and its internal control influences the inquiries made and analytical procedures performed. A significant change in control activities would likely result in further inquiry of management.
Choice "b" is incorrect. An accountant's knowledge of an entity's business and its internal control influences the inquiries made and analytical procedures performed. A significant change in control activities would likely result in the accountant employing analytical procedures with a more precise expectation, since more precise expectations are more effective at detecting misstatements. Choices "c" and "d" are incorrect. Only choice "a" is correct, as explained above.

QUESTION 264
Davidson, CPA, is performing a review under auditing standards of Gold's interim financial information.
As part of planning, Davidson reads the audit documentation from the preceding year's annual audit. Which of the following is least likely to affect Davidson's review?

A. A summary of both corrected and uncorrected misstatements.
B. Identified risks of material misstatement due to fraud.
C. Significant weaknesses in internal control.
D. Scope limitations that were overcome through acceptable alternative procedures.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Scope limitations relate to problems in performing the audit, and, especially since they were overcome, they would bear little relationship to procedures performed in a review.
Choice "a" is incorrect. The nature of corrected misstatements should be considered, as they may be indicative of an ongoing problem. Uncorrected misstatements must also be considered as misstatements in one period often affect subsequent periods.
Choice "b" is incorrect. Identified risks of material misstatement due to fraud help the accountant to identify the types of material misstatements that may occur in the interim financial information, and to consider the likelihood of their occurrence.
Choice "c" is incorrect. Consideration of significant weaknesses in internal control helps the accountant identify the types of material misstatements that may occur in the interim financial information, and to consider the likelihood of their occurrence.

QUESTION 265
The annual financial statements of a publicly held company have been audited, and its interim financial statements have been reviewed. Which of the following is true about the application of professional standards to this review?

A. PCAOB standards apply.

B. Statements on Standards for Accounting and Review Services apply.
C. Both PCAOB standards and SSARS apply.
D. None of the above.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. A review of the interim financial information of a publicly held company is conducted in accordance with PCAOB standards, and it is these standards which should be referenced in the auditor's review report. (Note, however, that the PCAOB has adopted, at least initially, generally accepted auditing standards in this area.)
Choices "b" and "c" are incorrect. Statements on Standards for Accounting and Review Services apply to reviews of the financial statements of nonissuers.
Choice "d" is incorrect. A review of the interim financial information of a publicly held company is conducted in accordance with PCAOB standards.

QUESTION 266
Which of the following is not a required procedure in an engagement to review the interim financial information of a publicly held entity?

A. Obtaining corroborating evidence about the entity's ability to continue as a going concern.
B. Comparing disaggregated revenue data for the current interim period with that of comparable prior periods.
C. Obtaining evidence that the interim financial information reconciles with the accounting records.
D. Inquiring of management about their knowledge of fraud or suspected fraud.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. A review of interim financial information is not designed to provide information regarding an entity's ability to continue as a going concern. Even if such information comes to the accountant's attention, the accountant is not required to corroborate it.
Choice "b" is incorrect. As part of a review, the accountant is required to compare disaggregated revenue data for the current interim period with that of comparable prior periods.
Choice "c" is incorrect. As part of a review, the accountant is required to obtain evidence that the interim financial information reconciles with the accounting

records.
Choice "d" is incorrect. As part of a review, the accountant is required to inquire of management about their knowledge of fraud, suspected fraud, or allegations of fraud.

QUESTION 267
In which case would the accountant be least likely to perform a review of interim financial information under PCAOB (auditing) standards?

A. Quarterly reports are required to be filed with the SEC.
B. Selected quarterly financial data is included in an annual report.
C. Quarterly financial data is included in the financial statements of a nonissuer.
D. The accountant is performing an initial audit of financial statements that include selected quarterly data.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. A review of data included in financial statements of a nonissuer is performed under Statements on Standards for Accounting and Review Services, not under PCAOB (auditing) standards. A review of interim financial information under PCAOB (auditing) standards is only conducted for public companies (or companies anticipating going public).
Choice "a" is incorrect. When an entity is required by the SEC to file a quarterly report, the SEC also requires that an independent accountant perform a review (of the interim financial information) in accordance with PCAOB (auditing) standards before the report is filed.
Choice "b" is incorrect. When a company is required by the SEC to include selected quarterly financial data in its annual report or in other SEC filings, a review (of the interim financial information) in accordance with PCAOB (auditing) standards is required.
Choice "d" is incorrect. An accountant performing an initial audit of financial statements that include selected quarterly data should also perform a review (of the interim financial information) in accordance with PCAOB (auditing) standards as part of the overall audit.

QUESTION 268
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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. If a report on a review of interim financial information is presented in a registration statement, the prospectus should include a statement that the report is not a "report" or "part" of the registration statement. The accountant should also read the other portions of the registration statement to ensure that his or her name is not used in a way that indicates greater responsibility than s/he intends.
Choice "b" is incorrect. The auditor is responsible to update the report for events occurring after the date of the report but prior to filing.
Choice "c" is incorrect. The accountant's review of interim financial information is performed in accordance with PCAOB standards, as approved (not established) by the SEC. Choice "d" is incorrect. Obtaining corroborating evidence is an audit procedure, not a review procedure.

QUESTION 269
The objective of a review of interim financial information of a public entity is to provide an accountant with a basis for reporting whether:

A. A reasonable basis exists for expressing an updated opinion regarding the financial statements that were previously audited.
B. Material modifications should be made to conform with generally accepted accounting principles.
C. The financial statements are presented fairly in accordance with standards of interim reporting.
D. The financial statements are presented fairly in accordance with generally accepted accounting principles.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. The objective of a review is to provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the accompanying financial statements for them to be in conformity with generally accepted accounting principles.
Choice "a" is incorrect. When performing a review, the accountant does not gather enough evidence to update an audit opinion.
Choice "c" is incorrect. There are no "standards of interim reporting."
Choice "d" is incorrect. Expressing an opinion as to whether the financial statements are presented fairly in accordance with GAAP is the result of an audit, not a review.

QUESTION 270

The quarterly data required by SEC Regulation S-K have been omitted. Which of the following statements must be included in the auditor's report?

A. The auditor was unable to review the data.
B. The company's internal control provides an adequate basis to complete the review.
C. The company has not presented the selected quarterly financial data.
D. The auditor will review the selected data during the review of the subsequent quarterly financial data.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. If the quarterly data required by SEC Regulation S-K have been omitted, the auditor's report must include a statement indicating that the company has not presented such data.
Choice "a" is incorrect. The auditor's report should only state that the auditor was unable to review quarterly data required by SEC Regulation S-K when the data have been included, but the auditor has not reviewed such data.
Choice "b" is incorrect. Generally, the auditor's report does not make reference to a review of interim financial information, since such information is not a required part of GAAP financial statements. (Note, however, that the auditor's report might be modified to indicate that the company's internal control was not sufficient to provide an adequate basis for a review of such information, in situations where quarterly data is included but not reviewed).
Choice "d" is incorrect. If an entity is required to file quarterly reports, a review of this quarterly data is also required. Such review should be completed before the quarterly report is filed, not postponed to a subsequent quarter.

QUESTION 271
Which of the following matters is covered in a typical comfort letter?

A. Negative assurance concerning whether the entity's internal controls 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.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. In a typical comfort letter, the accountants express an opinion (i.e., positive assurance) concerning the financial statements' compliance (as to form) with the pertinent accounting requirements of the SEC. Choice "a" is incorrect. No assurance is generally provided in a comfort letter regarding the operation of an entity's internal control.
Choice "b" is incorrect. A typical comfort letter is addressed to the underwriters of the securities.
Government Auditing Standards and the Single Audit Act are not applicable to a comfort letter related to the issuance of securities.
Choice "c" is incorrect. Negative assurance (not positive) is typically provided regarding unaudited condensed financial information.

QUESTION 272
Comfort letters ordinarily are signed by the client's:

A. Independent auditor.
B. Underwriter of securities.
C. Audit committee.
D. Senior management.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. A comfort letter is a letter containing a negative assurance from the CPA to the underwriter or certain other requesting parties just before the registration of the client's securities. Choice "b" is incorrect. The comfort letter is sent to the underwriter.
Choice "c" is incorrect. The audit committee does not sign a comfort letter.
Choice "d" is incorrect. Senior management may sign a client representation letter, not a comfort letter.

QUESTION 273
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.

Correct Answer: A
Section: Volume B

Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. 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 negative assurance on capsule information.
Choice "b" is incorrect. Positive assurance cannot be given if the information was not audited.
Choices "c" and "d" are incorrect. A comfort letter generally covers the period from the date of the last auditor's report to the effective date of the registration. It does not cover "pro forma" or prospective financial statements.

QUESTION 274
Comfort letters ordinarily are:

Addressed to the client's	Signed by the client's
Audit committee	Independent auditor
Underwriter of securities	Senior management
Audit committee	Senior management
Underwriter of securities	Independent auditor

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. A comfort letter is a letter from the independent auditor to the named underwriter just before the registration of the client's securities.
Choices "a", "b", and "c" are incorrect, based on the above .

QUESTION 275

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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Statements on Standards for Attestation Engagements provide guidance with respect to compilation of a financial projection, but they do not address services involving advocating for a client, such as testifying as an expert witness.
Choices "a", "b", and "d" are incorrect, per above .

QUESTION 276
In an attest engagement, use of the accountant's report should be restricted to specified parties in all of the following situations, except:

A. When the criteria used to evaluate the subject matter are appropriate for only a limited number of parties.
B. When reporting on an assertion about the subject matter instead of reporting directly on the subject matter.
C. When reporting directly on the subject matter and a written assertion has not been provided.

D. When reporting on an agreed-upon procedures engagement.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. There is no requirement that the accountant's report be restricted to specified parties when reporting on an assertion about the subject matter instead of reporting directly on the subject matter.
Choice "a" is incorrect, since use of the accountant's report should be restricted to specified parties when the criteria used to evaluate the subject matter are appropriate for only a limited number of parties.
Choice "c" is incorrect, since use of the accountant's report should be restricted to specified parties when reporting directly on the subject matter and a written assertion has not been provided. Choice "d" is incorrect, since use of the accountant's report should be restricted to specified parties when reporting on an agreed-upon procedures engagement.

QUESTION 277
Which of the following is a term for an attest engagement in which a CPA assesses a client's commercial Internet site for predefined criteria that are designed to measure transaction integrity, information protection, and disclosure of business practices?

A. ElectroNet.
B. EDIFACT.
C. TechSafe.
D. WebTrust.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. A WebTrust engagement is an attestation engagement designed to measure transaction integrity, information protection, and disclosure of business practices. When an unqualified report is issued, the client may add the CPA WebTrust Seal to its Web site, indicating that its site is a reasonably safe and private place for e-commerce. Choice "a" is incorrect. ElectroNet is an Internet service provider.
Choice "b" is incorrect. EDIFACT refers to standards developed by the United Nations for Electronic Data Interchange for Administration, Commerce, and Transport. These standards facilitate information flow among trading partners in many industries. The scope and format of these standards is similar, but not identical, to those developed in the United States. Choice "c" is incorrect. TechSafe is a distracter.

QUESTION 278
An entity engaged a CPA to determine whether the client's web sites meet defined criteria for standard business practices and controls over transaction integrity and information protection. In performing this engagement, the CPA should comply with the provisions of:

A. Statements on Assurance Standards.
B. Statements on Standards for Attestation Engagements.
C. Statements on Standards for Management Consulting Services.
D. Statements on Auditing Standards.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. A WebTrust engagement is an attestation engagement in which the CPA determines whether the client's web site meets defined criteria relating to transaction integrity, information protection, and disclosure of business practices. Attestation engagements should be performed in accordance with Statements on Standards for Attestation Engagements (SSAEs).
Choice "a" is incorrect. Statements on Assurance Standards is a distracter.
Choice "c" is incorrect. Consulting services provided by CPAs range from advice on accounting-related matters to a wide range of services involving diverse technical disciplines. Consulting services performed by CPAs should be performed in accordance with Statements on Standards for Consulting Services (SSCSs).
Choice "d" is incorrect. Audits (generally of financial statements) performed by CPAs should be performed in accordance with Statements on Auditing Standards (SASs).

QUESTION 279
A CPA's report on agreed-upon procedures related to management's assertion about 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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. The practitioner's report on agreed-upon procedures related to management's assertion about the entity's compliance with specified requirements is intended solely for the use of specified parties. Thus, the report should include a statement of limitations on the use of the report.
Choice "b" is incorrect. The report is in the form of procedures and findings. Since the work performed is less in scope than an examination, the accountant disclaims any opinion.
Choice "c" is incorrect. The auditor does not provide any negative assurance relative to assessment of control risk or to compliance with the specified requirements.
Choice "d" is incorrect. The report contains a statement that the sufficiency of the procedures is solely the responsibility of the parties specifying the procedures and a disclaimer of responsibility on the part of the accountant.

QUESTION 280
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 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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. The accountant's standard report on an examination of projected financial statements should include a caveat that the projected results may not be achieved. This is included in a separate paragraph that describes the limitations on the usefulness of the presentation: "...there will usually be differences between the forecasted and actual results... [that] may be material."
Choice "b" is incorrect. The accountant's report on the examination of projected financial statements would not include an of the differences between an examination and an audit.
Choice "c" is incorrect. A statement is included which specifically states that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.
Choice "d" is incorrect. The accountant does express an opinion that "the underlying assumptions provide a reasonable basis for management's forecast."

QUESTION 281

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.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. An examination of a financial forecast is a professional service that involves:
1) evaluating the preparation of the prospective financial statements,
2) evaluating the support underlying the assumptions,
3) evaluating the presentation of the prospective financial statements in conformity with AICPA guidelines, and4) issuing an examination report.
Choice "a" is incorrect. Compiling or assembling a financial forecast based on management's assumptions is part of a compilation engagement, not an examination engagement.
Choice "b" is incorrect. A financial forecast may be issued for general use.
Choice "c" is incorrect. The accountant's standard report specifically states that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

QUESTION 282
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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that certain conditions are met, including that the use of the report be restricted to the specified parties.
Choice "b" is incorrect. There is no requirement that the prospective financial statements be examined.
In fact, the practitioner's report on the application of agreed-upon procedures states that the auditor did not perform an examination.
Choice "c" is incorrect. The specified parties must understand that they take responsibility for the sufficiency of the attest procedures. Choice "d" is incorrect. No assurance is expressed in an agreed-upon procedures engagement.

QUESTION 283
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.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. The accountant's compilation report on a client's financial forecast should include a caveat that the prospective results may not be achieved.
Choice "a" is incorrect. The historical financial statements upon which the forecast is based need not be audited, nor must they accompany the forecast compilation.
Choice "b" is incorrect. The accountant expresses no assurance in the compilation report on forecasted statements.
Choice "d" is incorrect. A compilation of a financial forecast would not include evaluation of the support for the assumptions underlying the forecast.

QUESTION 284
Which of the following is a conceptual difference between the attestation standards and generally accepted auditing standards?

A. The attestation standards provide a framework for the attest function beyond historical financial statements.
B. The requirement that the practitioner be independent in mental attitude is omitted from the attestation standards.
C. The attestation standards do not permit an attest engagement to be part of a business acquisition study or a feasibility study.
D. None of the standards of fieldwork in generally accepted auditing standards are included in the attestation standards.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. Attestation standards provide a framework for the attest function beyond historical financial statements.
Choice "b" is incorrect. The independence standard is almost the same for both attest engagements and audits.
Choice "c" is incorrect. An attest engagement may be part of a larger engagement (such as a business acquisition study or a feasibility study).
Choice "d" is incorrect. Attestation standards include two of the three GAAS fieldwork standards: planning/supervision and evidence. They do not include the internal control standard.

QUESTION 285
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.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The accountant's report on a review of pro forma financial information should include a reference to the financial statements from which the historical information is derived and a statement as to whether such financial statements were audited or reviewed.
Choice "a" is incorrect. No statement on the entity's internal control is necessary.
Choice "b" is incorrect. If the auditor has audited the financial statements from which the pro forma financial information is derived, an opinion on those statements may be expressed.
Choice "c" is incorrect. The report on a review of pro forma financial information would include an of the objective and limitations of the information, but would not discuss the uncertainty surrounding occurrence of the transaction or event.

QUESTION 286
In performing an attest engagement, a CPA typically:

A. Supplies litigation support services.
B. Assesses control risk at a low level.
C. Issues a report on subject matter (or on an assertion about subject matter) that is the responsibility of another party.
D. Provides management consulting advice.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. In performing an attest engagement, a CPA typically issues a report on subject matter (or on an assertion about subject matter) that is the responsibility of another party.
Choice "a" is incorrect. Supplying litigation support services is not an attest engagement because the CPA is not reporting on subject matter (or an assertion about subject matter) that is the responsibility of another party.
Choice "b" is incorrect. An attest engagement may include a report on internal control; however, the assessed level of control risk may or may not be at a low level.
Choice "d" is incorrect. Management consulting advice is not considered to be an attest engagement because the CPA is not reporting on subject matter (or on an assertion about subject matter) that is the responsibility of another party.

QUESTION 287
An accountant's standard report on a compilation of a projection should not include a:

A. Statement that a compilation of a projection is limited in scope.
B. Disclaimer of responsibility to update the report for events occurring after the report's date.
C. Statement that the accountant expresses only limited assurance that the results may be achieved.
D. Separate paragraph that describes the limitations on the presentation's usefulness.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. A compilation of prospective financial statements is not intended to provide assurance on the prospective financial statements or the assumptions underlying such statements.
Choice "a" is incorrect. The report on a compilation should include a statement that a compilation is limited in scope.
Choice "b" is incorrect. The report on a compilation should include a statement that the accountant assumes no responsibility to update the report for events subsequent to the report date. Choice "d" is incorrect. The report on a compilation should include a separate paragraph that describes the limitations on the presentation's usefulness.

QUESTION 288
Which of the following is not an attestation standard?

A. Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.
B. The report shall identify the assertion being reported on and state the character of the engagement.
C. The work shall be adequately planned and assistants, if any, shall be properly supervised.
D. A sufficient understanding of internal control shall be obtained to plan the engagement.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. A sufficient understanding of internal control is not required to be obtained in an attestation engagement.
Choice "a" is incorrect. In an attestation engagement, sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.
Choice "b" is incorrect. An attestation report should identify the assertion being reported on and state the character of the engagement.
Choice "c" is incorrect. In an attestation engagement, the work should be adequately planned and assistants, if any, should be properly supervised.

QUESTION 289
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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. An accountant's compilation report on a financial forecast should include a statement that the compilation does not include evaluation of the support of the assumptions underlying the forecast. (An examination of the financial forecast would include evaluation of the support).
Choice "b" is incorrect. An accountant does not give any form of assurance related to hypothetical assumptions, which are not used in financial forecasts anyway. (Hypothetical assumptions are used in financial projections). Choice "c" is incorrect. No mention of the range of assumptions selected is made in the compilation report.
Choice "d" is incorrect. A compilation is limited to presenting, in the form of a forecast, information that is management's representation.

QUESTION 290
An attest engagement is one in which a CPA is engaged to:

A. Issue an examination, a review, or an agreed-upon procedures report on subject matter, or on an assertion about the subject matter, that is the responsibility of another party.
B. Provide tax advice or prepare a tax return based on financial information the CPA has not audited or reviewed.
C. Testify as an expert witness in accounting, auditing, or tax matters, given certain stipulated facts.
D. Assemble the financial statements of a nonissuer based on the assumptions of the entity's management without expressing any assurance.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. An attest engagement is one in which a CPA is engaged to issue an examination, a review, or an agreed-upon procedures report on subject matter, or on an assertion about subject matter, that is the responsibility of another party.
Choice "b" is incorrect. Providing tax advice or preparing a tax return based upon financial information the CPA has not audited or reviewed does not require the CPA to "attest" to anything.
Choice "c" is incorrect. Testifying as an expert witness in accounting, auditing, or tax matters given certain stipulated facts is not considered to be an attestation engagement.
Choice "d" is incorrect. Assembling the financial statements of a nonissuer based on the assumptions of the entity's management without expressing any assurance is a compilation engagement that falls under SSARS and no attestation is provided.

QUESTION 291
Which of the following professional services would be considered an attest engagement?

A. A management consulting engagement to provide EDP advice to a client.
B. An engagement to report on management's discussion and analysis (MD&A).
C. An income tax engagement to prepare federal and state tax returns.
D. The compilation of financial statements from a client's accounting records.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. An engagement to report on management's discussion and analysis (MD&A) would be considered an attest engagement, because the accountant is issuing an examination, review, or agreed-upon procedures report on another party's assertion.
Choice "a" is incorrect. A management consulting engagement to provide EDP advice to a client is not considered to be an attest engagement, because the accountant is not issuing an examination, review, or agreed-upon procedures report on another party's assertion.
Choice "c" is incorrect. An income tax engagement to prepare federal and state tax returns is not considered to be an attest engagement.
Choice "d" is incorrect. The compilation of financial statements from a client's accounting records (a compilation engagement) is not considered to be an attest engagement. (Note that although a compilation of prospective financial statements is covered under Statements on Standards for Attestation Engagements, the question-does not indicate that prospective financial statements are involved).

QUESTION 292
Which of the following statements concerning prospective financial statements is correct?

A. Only a financial forecast would normally be appropriate for limited use.
B. Only a financial projection would normally be appropriate for general use.
C. Any type of prospective financial statements would normally be appropriate for limited use.
D. Any type of prospective financial statements would normally be appropriate for general use.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Any type of prospective financial statements (financial forecasts and financial projections) would normally be appropriate for limited use.
Choice "a" is incorrect. Both financial forecasts and financial projections are appropriate for limited use.
Choice "b" is incorrect. Financial projections are appropriate for limited use only - not for general use.
Choice "d" is incorrect. Normally financial projections are not appropriate for general use, but financial forecasts are.

QUESTION 293
Negative assurance may be expressed when an accountant is requested to report on the:

A. Compilation of prospective financial statements.
B. Compliance with the provisions of the Foreign Corrupt Practices Act.
C. Results of performing a review of management's assertion.
D. Audit of historical financial statements.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Negative assurance may be expressed when an accountant is requested to report on the results of performing a review of management's assertion. Choice "a" is incorrect. No assurance is provided in a compilation of prospective financial statements.
Choice "b" is incorrect. Whether an entity is in compliance with the provisions of the Foreign Corrupt Practices Act is a legal determination. An accountant may perform an examination or an agreed-upon procedures engagement with respect to such compliance but may not perform a review, and therefore would not express negative assurance.
Choice "d" is incorrect. When reporting on an audit of historical financial statements, negative assurance is not an appropriate reporting option. The auditor must either express an opinion (positive assurance) or disclaim an opinion (no assurance).

QUESTION 294
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 (an):

A. "Except for" qualified opinion.
B. "Subject to" qualified opinion.
C. Unqualified opinion with a separate explanatory paragraph.
D. Adverse opinion.

Correct Answer: D

Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. When an accountant examines a financial forecast that fails to disclose significant assumptions used to prepare the forecast, the accountant should issue an adverse opinion.
Choice "a" is incorrect. A qualified opinion might be appropriate when AICPA presentation guidelines are not followed, but would not be used when "several significant assumptions used to prepare the forecast" are not disclosed. Choice "b" is incorrect. "Subject to" is not acceptable wording for an accountant's report. Choice "c" is incorrect. An unqualified opinion is not acceptable when significant assumptions are not disclosed.

QUESTION 295
Prospective financial information presented in the format of historical financial statements that omit either gross profit or net income is deemed to be a:

A. Partial presentation.
B. Projected balance sheet.
C. Financial forecast.
D. Financial projection.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. "Partial presentations" are presentations of prospective financial information which would not ordinarily be appropriate for general use because they omit one or more of these essential elements: (a) sales or gross revenue, (b) gross profit or cost of sales, (c) unusual or infrequently occurring items, (d) provision for income taxes, (e) discontinued operations or extraordinary items, (f) income from continuing operations, (g) net income, (h) earnings per share, and (i) significant changes in financial position.
Choices "b", "c", and "d" are incorrect. Projected balance sheets, financial forecasts and financial projections are forms of prospective financial statements.

QUESTION 296
Which of the following activities would most likely be considered an attestation engagement?

A. Consulting with management representatives of a firm to provide advice.
B. Issuing a report about a firm's compliance with laws and regulations.

C. Advocating a client's position on tax matters that are being reviewed by the IRS.
D. Preparing a client's tax returns.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Attest engagements may result in reports related to compliance with laws and regulations.
Choices "a", "c", and "d" are incorrect. Attestation engagements specifically exclude consulting services, advocacy services, and return preparation.

QUESTION 297
Which of the following professional services would be considered an attestation engagement?

A. Advocating on behalf of a client about trust tax matters under review by the Internal Revenue Service.
B. Providing financial analysis, planning, and capital acquisition services as a part-time, in-house controller.
C. Advising management in the selection of a computer system to meet business needs.
D. Preparing the income statement and balance sheet for one year in the future based on client expectations and predictions.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Preparing future financial statements constitutes a compilation of prospective financial statements, which is considered to be an attestation service. Choices "a" and "c" are incorrect. Attestation engagements specifically exclude advocacy services and consulting services.
Choice "b" is incorrect. Attest engagements include those in which a practitioner is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or on an assertion about the subject matter, that is the responsibility of another party, as well as engagements related to prospective financial statements. Performing the role of in-house controller part-time does not fit into any of these categories.

QUESTION 298
When an accountant compiles a financial forecast, the accountant's report should include a(an):

A. of the differences between a financial forecast and a financial projection.

B. Caveat that the prospective results of the financial forecast may not be achieved.
C. Statement that the accountant's responsibility to update the report is limited to one year.
D. Disclaimer of opinion on the reliability of the entity's internal controls.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Whenever an accountant reports on prospective financial statements, the report should include a caveat that prospective results may not be achieved.
Choice "a" is incorrect. A compilation report on a financial forecast does not include an of the differences between a forecast and a projection.
Choice "c" is incorrect. Whenever an accountant reports on prospective financial statements, the report should include a statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.
Choice "d" is incorrect. A compilation report on a financial forecast does not include a disclaimer of opinion on the reliability of the entity's internal controls.

QUESTION 299
Which of the following is a professional engagement that a CPA may perform to provide assurance on a system's reliability?

A. MAS AssurAbility.
B. CPA WebMaster.
C. MAS AttestSure.
D. CPA SysTrust.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. A SysTrust engagement is an attest engagement that provides assurance on the reliability of any defined electronic system. Choice "a" is incorrect. There is no professional engagement by this name.
Choice "b" is incorrect. There is no professional engagement by this name. Choice "c" is incorrect. There is no professional engagement by this name.

QUESTION 300
An accountant's standard report on a compilation of a projection should not include a statement that:

A. There will usually be differences between the forecasted and actual results.
B. The hypothetical assumptions used in the projection are reasonable in the circumstances.
C. The accountant has no responsibility to update the report for future events and circumstances.
D. The compilation of a projection is limited in scope.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. An accountant's standard report on a compilation of a projection does not include a statement that the hypothetical assumptions used in the projection are reasonable in the circumstances.
Choice "a" is incorrect. An accountant's standard report on a compilation of a projection does state that there will usually be differences between the forecasted and actual results.
Choice "c" is incorrect. An accountant's standard report on a compilation of a projection does state that the accountant has no responsibility to update the report for future events and circumstances.
Choice "d" is incorrect. An accountant's standard report on a compilation of a projection does state that the compilation of a projection is limited in scope ("A compilation is limited to presenting in the form of a projection information that is the representation of management and does not include evaluation of the support for the assumptions underlying the projection.")

QUESTION 301
A practitioner's report on agreed-upon procedures that is in the form of procedures and findings should contain:

A. Negative assurance that the procedures did not necessarily disclose all significant deficiencies in internal control.
B. An acknowledgment of the practitioner's responsibility for the sufficiency of the procedures.
C. A statement of restrictions on the use of the report.
D. A disclaimer of opinion on the entity's financial statements.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:

Section: Volume B

Choice "c" is correct. A practitioner's report on agreed-upon procedures that is in the form of procedures and findings should contain a statement of restrictions on the use of the report. Choice "a" is incorrect. Agreed-upon procedures engagements do not provide assurance of any sort.
Choice "b" is incorrect. The responsible party (not the practitioner) is responsible for the sufficiency of the procedures.
Choice "d" is incorrect. The subject matter of an agreed-upon procedures engagement varies, and may be unrelated to the financial statements.

QUESTION 302
When an accountant compiles projected financial statements, the accountant's report should include a separate paragraph that:

A. Explains the difference between a compilation and a review.
B. Documents the assessment of the risk of material misstatement due to fraud.
C. Expresses limited assurance that the actual results may be within the projected range.
D. Describes the limitations on the projection's usefulness.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The accountant's report on compiled projected financial statements should include a separate paragraph that describes the limitations on the projection's usefulness. For example, the paragraph states that there will usually be differences between projected and actual results, and indicates that the accountant has no responsibility to update the report for events occurring after the date of the report.
Choice "a" is incorrect. The accountant's report on compiled projected financial statements does not include an of the difference between a compilation and a review.
Choice "b" is incorrect. The accountant's report on compiled projected financial statements does not document the assessment of the risk of material misstatement due to fraud.
Choice "c" is incorrect. The accountant's report on compiled projected financial statements does not express limited assurance that the actual results may be within the projected range. In fact, it specifically states that no opinion or any other form of assurance is expressed, and that there usually will be differences between projected and actual results.

QUESTION 303
A CPA is engaged to examine management's assertion that the entity's schedule of investment returns is presented in accordance with specific criteria. In performing this engagement, the CPA should comply with the provisions of:

A. Statements on Standards for Accounting and Review Services (SSARS).
B. Statements on Auditing Standards (SAS).

C. Statements on Standards for Consulting Services (SSCS).
D. Statements on Standards for Attestation Engagements (SSAE).

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Statements on Standards for Attestation Engagements apply to engagements in which a practitioner is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or on an assertion about the subject matter, which is the responsibility of another party. An engagement to examine management's assertion that the entity's schedule of investment returns is presented in accordance with specific criteria would fall within this scope.
Choice "a" is incorrect. Statements on Standards for Accounting and Review Services apply to engagements involving the unaudited financial statements of a nonissuer. An engagement to examine management's assertion that the entity's schedule of investment returns is presented in accordance with specific criteria does not fall within this scope.
Choice "b" is incorrect. Statements on Auditing Standards apply to audits of financial statements. An engagement to examine management's assertion that the entity's schedule of investment returns is presented in accordance with specific criteria does not fall within this scope.
Choice "c" is incorrect. Statements on Standards for Consulting Services apply to a broad range of consulting services. An engagement to examine management's assertion that the entity's schedule of investment returns is presented in accordance with specific criteria is not a consulting service.

QUESTION 304
An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided the:

A. Provisions of Statements on Standards for Accounting and Review Services (SSARS) are followed.
B. Accountant also examines the prospective financial statements.
C. Distribution (use) of the report is restricted to the specified users.
D. The accountant takes responsibility for the adequacy of the procedures performed.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. In an agreed-upon procedures engagement, use of the report is restricted to the specified users.

Choice "a" is incorrect. Statements on Standards for Accounting and Review Services apply to the unaudited financial statements of a nonissuer, not to engagements to apply agreed-upon procedures to prospective financial statements.
Choice "b" is incorrect. There is no requirement that the accountant also examine prospective financial statements in an agreed-upon procedures engagement.
Choice "d" is incorrect. In an agreed-upon procedures engagement, the specified parties (and not the accountant) take responsibility for the sufficiency of the procedures for their purposes.

QUESTION 305
Accepting an engagement to compile a financial projection for a publicly held company most likely would be inappropriate if the projection were to be distributed to:

A. A bank with which the entity is negotiating for a loan.
B. A labor union with which the entity is negotiating a contract.
C. The principal stockholder, to the exclusion of the other stockholders.
D. All stockholders of record as of the report date.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Accepting an engagement to compile a financial projection for a publicly held company most likely would be inappropriate if the projection were to be distributed to all stockholders of record as of the report date (general use). Only a financial forecast is suitable for general use.
Choices "a", "b", and "c" are incorrect. Financial projections are for limited use, and may be used by the responsible party alone (choice "c" - the principal stockholder only), or by the responsible party and third parties with whom the responsible party is negotiating directly (choices "a" and "b"- a bank or a labor union with which the entity is negotiating).

QUESTION 306
When an accountant compiles projected financial statements, the accountant's report should include a separate paragraph that:

A. Describes the differences between a projection and a forecast.
B. Identifies the accounting principles used by management.
C. Expresses limited assurance that the actual results may be within the projection's range.
D. Describes the limitations on the projection's usefulness.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The report on compiled projected financial statements should include a separate paragraph that describes the limitations on the usefulness of the presented statements. Choice "a" is incorrect. The accountant's report on a compilation of a forecast or a projection does not describe the differences between them.
Choice "b" is incorrect. The report would not identify the accounting principles used by management.
Choice "c" is incorrect. A report on compiled projected financial statements does not express any assurance regarding the achievability of results.

QUESTION 307
A CPA firm should establish procedures for conducting and supervising work at all organizational levels to provide reasonable assurance that the work performed meets the firm's standards of quality. To achieve this goal, the firm most likely would establish procedures for:

A. Evaluating prospective and continuing client relationships.
B. Reviewing audit documentation and engagement reports.
C. Requiring personnel to adhere to the applicable independence rules.
D. Maintaining personnel files containing documentation related to the evaluation of personnel.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Procedures for reviewing audit documentation and engagement reports are established to ensure that the work performed meets the firm's quality standards. This relates to the quality control element of engagement performance.
Choice "a" is incorrect. Evaluations of prospective and continuing client relationships are performed to minimize the likelihood of association with a client whose management lacks integrity. This relates to the quality control element of acceptance and continuance of clients and engagements. Such evaluations do not ensure that the work performed meets the firm's quality control standards Choice "c" is incorrect. Requiring personnel to adhere to the applicable independence rules relates to the quality control element of independence, integrity, and objectivity. Such requirements are established to provide independence, but they do not ensure that the work performed meets the firm's quality control standards.
Choice "d" is incorrect. Maintaining personnel files and periodic evaluations of personnel are part of the quality control element of personnel management. Such policies are established to provide for appropriate hiring, assignment, development, and advancement of employees, but they would not ensure that the work performed meets the firm's quality control standards.

QUESTION 308
Which of the following are elements of a CPA firm's quality control that should be considered in establishing its quality control policies and procedures?

	Engagement Performance	Independence	Monitoring
A.	Yes	Yes	No
B.	Yes	Yes	Yes
C.	No	Yes	Yes
D.	Yes	No	Yes

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Quality control elements are:
(1) Independence, integrity, and objectivity,
(2) Personnel management,
(3) Acceptance and continuance of clients and engagements,(4) Engagement performance, and (5) Monitoring.
Choices "a", "c", and "d" are incorrect based on the above .

QUESTION 309
A CPA firm would be reasonably assured of meeting its responsibility to provide services that conform with professional standards by:

A. Adhering to generally accepted auditing standards.
B. Having an appropriate system of quality control.
C. Joining professional societies that enforce ethical conduct.
D. Maintaining an attitude of independence in its engagements.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Quality control standards relate to the conduct of a firm's audit practice. They set forth standards for the establishment of policies and procedures to provide reasonable assurance of conforming with professional standards.
Choice "a" is incorrect. GAAS relate to the conduct of individual audit engagements.
Choice "c" is incorrect. Joining professional societies that enforce ethical conduct (e.g., the AICPA or state CPA society) will not assure the firm of meeting its responsibility to conform with GAAS. A system of policies and procedures (i.e., a system of quality control) must be established to provide this assurance.
Choice "d" is incorrect. Independence is part of the quality control element of independence, integrity, and objectivity, but maintaining independence alone will not help the firm meet its responsibility to conform with professional standards.

QUESTION 310
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 reporting standards.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. A system of quality control establishes policies and procedures that provide reasonable assurance of conforming with professional standards.
Choice "b" is incorrect. Peer review is a process whereby one CPA firm reviews another. It can be part of the monitoring element of quality control, but it does not (in and of itself) provide reasonable assurance that a CPA firm will comply with professional standards.
Choice "c" is incorrect. The objective of continuing professional education (CPE) is to increase the competency of auditors. Professional development activities such as this are part of the personnel management element of quality control, but they do not (in and of themselves) provide reasonable assurance that a CPA

firm will comply with professional standards.
Choice "d" is incorrect. Compliance with the standards of reporting (part of the ten generally accepted auditing standards) helps ensure that audit results are appropriately communicated to the users of financial statements, but such compliance does not provide assurance regarding conformity with professional standards.

QUESTION 311
Which of the following is not a comprehensive basis of accounting other than generally accepted accounting principles?

A. Cash receipts and disbursements basis of accounting.
B. Basis of accounting used by an entity to file its income tax return.
C. Basis of accounting used by an entity to comply with the financial reporting requirements of a government regulatory agency.
D. Basis of accounting used by an entity to comply with the financial reporting requirements of a lending institution.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. A basis of accounting used by an entity to comply with the financial reporting requirements of a lending institution is not a comprehensive basis because such a requirement, in itself, would not have substantial support. A comprehensive basis of accounting other than GAAP is one of the following:
1. Cash basis and modified cash basis
2. Tax basis
3. Prescribed regulatory basis
4. Other basis with substantial support (e.g., price-level basis). Choices "a", "b", and "c" are incorrect, as explained above.

QUESTION 312
Which of the following accounting bases may be used to prepare financial statements in conformity with a comprehensive basis of accounting other than generally accepted accounting principles?
I. Basis of accounting used by an entity to file its income tax return.
II. Cash receipts and disbursements basis of accounting.

A. I only.
B. II only.
C. Both I and II.
D. Neither I nor II.

Correct Answer: C

Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Both the basis of accounting used by an entity to file its income tax return and the cash receipts and disbursements basis of accounting are comprehensive bases of accounting other than GAAP. OCBOAs also include:
* A basis prescribed by a regulatory agency
* A definite set of criteria having substantial support (e.g., price-level basis)

QUESTION 313
A CPA is required to comply with the provisions of Statements on Standards for Accounting and Review Services when:

	Proposing correcting journal entries to the financial statements	*Preparing standard monthly journal entries*
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. A CPA is not required to comply with the provisions of Statements on Standards for Accounting and Review Services when proposing correcting journal entries or preparing standard monthly journal entries, since these activities do not constitute a "submission" of financial statements. Choices "a", "b", and "c" are incorrect, per above .

QUESTION 314
An auditor's special report on financial statements prepared in conformity with the cash basis of accounting should include a separate explanatory paragraph before the opinion 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 another comprehensive basis of accounting.
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.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. An auditor's special report on financial statements prepared in conformity with the cash basis of accounting should include a separate explanatory paragraph before the opinion paragraph that refers to the note to the financial statements that describes the basis of accounting.
Choice "a" is incorrect. The auditor should not include a separate explanatory paragraph that justifies the reasons for any departure from GAAP.
Choice "b" is incorrect. The opinion paragraph (not the preceding explanatory paragraph) states whether the financial statements are fairly presented in conformity with the other comprehensive basis of accounting. Choice "d" is incorrect. The auditor's report does not explain the differences between GAAP and the OCBOA, but merely states that they are different.

QUESTION 315
The standard report issued by an accountant after reviewing the financial statements of a nonissuer states that:

A. A review includes assessing the accounting principles used and significant estimates made by management.
B. A review includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
C. The accountant is not aware of any material modifications that should be made to the financial statements.
D. The accountant does not express an opinion or any other form of assurance on the financial statements.

Correct Answer: C
Section: Volume B

Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. The standard report issued by an accountant after reviewing the FS of a nonissuer states that the accountant is not aware of any material modifications that should be made to the financial statements (see the third paragraph of the standard review report). This is a "negative assurance."
Choice "a" is incorrect. The standard audit report includes a statement regarding assessing the accounting principles used and significant estimates made by management.
Choice "b" is incorrect. The standard audit report includes a statement regarding examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
Choice "d" is incorrect. A compilation report states that the accountant does not express an opinion or any other form of assurance on the financial statements. A review report provides limited assurance.

QUESTION 316
Which of the following procedures is not usually performed by the accountant during a review engagement of a nonissuer?

A. Inquiring about actions taken at meetings of the board of directors that may affect the financial statements.
B. Issuing a report stating that the review was performed in accordance with standards established by the AICPA.
C. Reading the financial statements to consider whether they conform with generally accepted accounting principles.
D. Communicating any material weaknesses discovered during the consideration of internal control.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Since internal control inquiries are not part of a review, there is generally no consideration of internal control in a review engagement.
Choice "a" is incorrect. Inquiries to be made during a review may relate to meetings of the board of directors.
Choice "b" is incorrect. A standard review report does state that the review was performed in accordance with SSARS, issued by the AICPA. Choice "c" is incorrect. Analytical procedures to be performed during a review should include reading the financial statements.

QUESTION 317
When reporting on financial statements prepared on the same basis of accounting used for income tax purposes, the auditor should include in the report a paragraph that:

A. States that the income tax basis of accounting is a comprehensive basis of accounting other than generally accepted accounting principles.
B. Justifies the use of the income tax basis of accounting.
C. Emphasizes that the financial statements are not intended to have been audited in accordance with generally accepted auditing standards.
D. Refers to the authoritative pronouncements that explain the income tax basis of accounting being used.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. When reporting on financial statements prepared on the same basis of accounting used for income tax purposes, the auditor should include in the report a paragraph that states that the income tax basis of accounting is a comprehensive basis of accounting other than GAAP (included in the third paragraph of the special report).
Choice "b" is incorrect. The special report does not justify the use of the income tax basis of accounting.
Choice "c" is incorrect. The financial statements are audited in accordance with GAAS (as stated in the first sentence in the second paragraph of the report).
Choice "d" is incorrect. The report does not refer to the authoritative pronouncements that explain the income tax basis of accounting being used.

QUESTION 318
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 Statements on Standards for Accounting and Review Services issued 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.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. An accountant's standard compilation report of an entity's financial statements should not include a statement that the accountant does not express an opinion but expresses only limited assurance on the financial statements. An accountant should not express any level of assurance on compiled

financial statements.
Choice "a" is incorrect. An accountant's standard compilation report should include the statement that the compilation was performed in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.
Choice "b" is incorrect. An accountant's standard compilation report should include the statement that the accountant has not audited or reviewed the financial statements.
Choice "d" is incorrect. An accountant's standard compilation report should include the statement that a compilation is limited to presenting, in the form of financial statements, information that is the representation of management.

QUESTION 319
The objective of a review of interim financial information of a public entity is to provide the accountant with a basis for:

A. Determining whether the prospective financial information is based on reasonable assumptions.
B. Expressing a limited opinion that the financial information is presented in conformity with generally accepted accounting principles.
C. Deciding whether to perform substantive audit procedures prior to the balance sheet date.
D. Reporting whether material modifications should be made for such information to conform with generally accepted accounting principles.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The objective of a review of interim financial information of a public entity is to provide the accountant with a basis for reporting whether material modifications should be made to conform with GAAP. Choice "a" is incorrect. Prospective financial information (concerning future events) is not part of the interim financial information filed by a public company.
Choice "b" is incorrect. No form of opinion is expressed based on a review; however, limited assurance is provided regarding the financial statements. Choice "c" is incorrect. The objective of an interim review is not to provide guidance regarding the timing of audit procedures.

QUESTION 320
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Financial statements of a nonissuer that have been compiled should be accompanied by a report explicitly stating that the accountant has compiled the financial statements and stating that the accountant has not audited or reviewed the financial statements.
Choices "a", "c", and "d" are incorrect, since these representations are made explicitly as per above.

QUESTION 321
Financial statements of a nonissuer that have been reviewed by an accountant should be accompanied by a report stating that:

A. The scope of the inquiry and analytical procedures performed by the accountant has not been restricted.
B. All information included in the financial statements is the representation of the management of the entity.
C. 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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Financial statements of a nonissuer that have been reviewed by an accountant should be accompanied by a report stating that all information included in the financial statements is the representation of the management of the entity (per the first paragraph of the review report).
Choice "a" is incorrect. The report does not state that the scope of the inquiry and analytical procedures performed by the accountant has not been restricted.
Choice "c" is incorrect. An audit (and not a review) includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
Choice "d" is incorrect. The report does not state that a review is greater in scope than a compilation. In addition, presenting financial statements that are free of material misstatements is not the objective of a compilation.

QUESTION 322
Performing inquiry and analytical procedures is the primary basis for an accountant to issue a:

A. Report on compliance with requirements governing major federal assistance programs in accordance with the Single Audit Act.
B. Review report on prospective financial statements that present an entity's expected financial position, given one or more hypothetical assumptions.
C. Management advisory report prepared at the request of a client's audit committee.
D. Review report on comparative financial statements for a nonissuer in its second year of operations.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Performing inquiry and analytical procedures is the primary basis for an accountant to issue a review report on comparative financial statements for a nonissuer in its second year of operations.
Choice "a" is incorrect. Reporting on compliance with requirements governing major federal assistance programs in accordance with the Single Audit Act is an attest engagement designed to provide a high level of assurance on an assertion (an "examination"). Inquiry and analytical procedures alone generally would be insufficient to support this level of assurance.
Choice "b" is incorrect. Prospective financial statements that present an entity's expected financial position (given one or more hypothetical assumptions) may be subject to (1) an examination; (2) a compilation; or (3) agreed-upon procedures; but not to a review.
Choice "c" is incorrect. Management advisory services (also known as consulting services) require the accountant to develop findings, conclusions, and recommendations. Generally this would require procedures beyond inquiry and analytical procedures.

QUESTION 323
An auditor's report on financial statements prepared in accordance with an other comprehensive basis of accounting should include all of the following, except:

A. An opinion as to whether the basis of accounting used is appropriate under the circumstances.
B. An opinion as to whether the financial statements are presented fairly in conformity with the other comprehensive basis of accounting.
C. Reference to the note to the financial statements that describes the basis of presentation.
D. A statement that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. The auditor would not indicate in his/her report an opinion as to whether the method of accounting used is appropriate.
Choice "b" is incorrect. The auditor would include in his report an opinion as to whether the financial statements are presented fairly in conformity with the other comprehensive basis of accounting.
Choice "c" is incorrect. The auditor would include in his report reference to the note to the financial statements that describes the basis of presentation.
Choice "d" is incorrect. The auditor would include in his report a statement that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.

QUESTION 324
When an independent accountant's report based on a review of interim financial information is presented in a registration statement, a prospectus should include a statement about the accountant's involvement.
This statement should clarify that the:

A. Accountant is not an "expert" within the meaning of the Securities Act of 1933.
B. Accountant's review report is not a "part" of the registration statement within the meaning of the Securities Act of 1933.
C. Accountant performed only limited auditing procedures on the interim financial statements.
D. Accountant's review was performed in accordance with standards established by the American Institute of CPAs.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:

Section: Volume B

Choice "b" is correct. When an independent accountant's report based on a review of interim financial information is presented in a registration statement, the prospectus should include a statement clarifying that the accountant's review report is not a "part" of the registration statement within the meaning of the Securities Act of 1933.
Choice "a" is incorrect. The accountant is an "expert" within the meaning of the Securities Act of 1933.
Choice "c" is incorrect. The accountant generally does not perform any auditing procedures during a review.
Choice "d" is incorrect. The fact that the accountant's review is performed in accordance with standards established by the AICPA is not mentioned in the statement (about the accountant's involvement) in the prospectus.

QUESTION 325
Before issuing a report on the compilation of financial statements of a nonissuer, the accountant should:

A. Apply analytical procedures to selected financial data to discover any material misstatements.
B. Corroborate at least a sample of the assertions management has embodied in the financial statements.
C. Inquire of the client's personnel whether the financial statements omit substantially all disclosures.
D. Read the financial statements to consider whether the financial statements are free from obvious material errors.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Before issuing a report on the compilation of financial statements of a nonissuer, the accountant should read the financial statements to consider whether the financial statements are free from obvious material errors. Choice "a" is incorrect. Application of analytical procedures is a review procedure, and is not required in a compilation engagement.
Choice "b" is incorrect. Corroboration of a sample of management assertions is an audit procedure, and is not required in a compilation engagement.
Choice "c" is incorrect. Inquiry is generally a review procedure; however, it should also be obvious to the accountant if substantially all disclosures are omitted.

QUESTION 326
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:

A. Issue an adverse opinion.
B. Issue an "except for" qualified opinion.
C. Disclose this departure from generally accepted accounting principles in a separate paragraph of the report.

D. Express only limited assurance on the financial statement presentations.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. If, 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, and management refuses to correct the financial statement presentations, the accountant should disclose this departure from GAAP in a separate paragraph of the report.
Choices "a" and "b" are incorrect. Adverse opinions and "except for" qualified opinions pertain to audit reports. Opinions are not rendered based on review engagements.
Choice "d" is incorrect. The accountant expresses only limited assurance on the financial statements as a result of a review even when there are no GAAP departures. GAAP departures require that a separate paragraph be added to the standard report, and that the limited assurance be modified to read, "...with the exception of the matter described in the following paragraph, I am not aware of any material modifications..."

QUESTION 327
Unaudited 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 andI. 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.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Either I or II.
Unaudited FS for the prior year presented in comparative form with audited FS for the current year should be clearly marked to indicate their status ("unaudited"), and either the report on the prior period should be reissued or the report on the current period should include a separate explanatory paragraph describing the responsibility assumed for the prior period's financial statements.

QUESTION 328
Comfort letters ordinarily are addressed to:

A. The Securities and Exchange Commission.
B. Underwriters of securities.
C. Creditor financial institutions.
D. The client's audit committee.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Comfort letters (containing comments on data that have not been audited) ordinarily are addressed to underwriters of securities, and most likely convey negative assurance on financial information. Choice "a" is incorrect. The SEC is not the addressee.
Choice "c" is incorrect. Creditor financial institutions are not the addressees.
Choice "d" is incorrect. While the client (or its audit committee) may receive a copy, ordinarily comfort letters are addressed to the underwriters.

QUESTION 329
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
Land, the engagement supervisor, decided not to reissue the prior year's auditors' report, but instructed Kent to include a separate paragraph in the current year's review report describing the responsibility assumed for the prior year's audited financial statements. This is an appropriate reporting procedure.
Land reviewed Kent's draft and indicated in the Supervisor's Review Notes below that there were several deficiencies in Kent's draft.
Accountant's Review Report
We have reviewed and audited the accompanying balance sheets of Tech Co. as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants and generally accepted auditing standards. All information included in these financial statements is the representation of the management of Tech Co.
A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole.
Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements. Because of the inherent limitations of a review engagement, this report is intended for the information of management and should not be used for any other purpose.

The financial statements for the year ended December 31, 20X1, were audited by us and our report was dated March 2, 20X2. We have no responsibility for updating that report for events and circumstances occurring after that date.
Jordan and Stone, CPAs
March 1, 20X3
Supervisor's Review Notes
There should be no reference to the prior year's audited financial statements in the first (introductory) paragraph.

A. Correct
B. Incorrect

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Correct. The auditors are issuing a review report this year and issued an audit opinion last year. A review report gives less assurance than an audit. The auditors should not make reference in the first paragraph to the fact that they audited last year's financial statements even though they are being comparatively shown, because it may mislead the reader of the financial statements as to the auditors' degree of assurance on this year's financial statements.

QUESTION 330
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Land reviewed Kent's draft and indicated in the Supervisor's Review Notes below that there were several deficiencies in Kent's draft.
Accountant's Review Report
We have reviewed and audited the accompanying balance sheets of Tech Co. as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants and generally accepted auditing standards. All information included in these financial statements is the representation of the management of Tech Co.
A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole.
Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements. Because of the inherent limitations of a review engagement, this report is intended for the information of management and should not be used for any other purpose.
The financial statements for the year ended December 31, 20X1, were audited by us and our report was dated March 2, 20X2. We have no responsibility for

updating that report for events and circumstances occurring after that date.
Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
All the current-year basic financial statements are not properly identified in the first (introductory) paragraph.

A. Correct
B. Incorrect

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Incorrect. The basic financial statements are properly identified in the introductory paragraph.

QUESTION 331
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
Land, the engagement supervisor, decided not to reissue the prior year's auditors' report, but instructed Kent to include a separate paragraph in the current year's review report describing the responsibility assumed for the prior year's audited financial statements. This is an appropriate reporting procedure.
Land reviewed Kent's draft and indicated in the Supervisor's Review Notes below that there were several deficiencies in Kent's draft.
Accountant's Review Report
We have reviewed and audited the accompanying balance sheets of Tech Co. as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants and generally accepted auditing standards. All information included in these financial statements is the representation of the management of Tech Co.
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The financial statements for the year ended December 31, 20X1, were audited by us and our report was dated March 2, 20X2. We have no responsibility for updating that report for events and circumstances occurring after that date.
Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
There should be no reference to the American Institute of Certified Public Accountants in the first (introductory) paragraph.

A. Correct
B. Incorrect

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Incorrect. There is and should be a reference to the American Institute of Certified Public Accountants in the first paragraph because the auditors are performing a review this year and not an audit.

QUESTION 332
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
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Kent to include a separate paragraph in the current year's review report describing the responsibility assumed for the prior year's audited financial statements. This is an appropriate reporting procedure. Land reviewed Kent's draft and indicated in the Supervisor's Review Notes below that there were several deficiencies in Kent's draft.
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Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
The accountant's review and audit responsibilities should follow management's responsibilities in the first (introductory) paragraph.

A. Correct
B. Incorrect

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Incorrect. The accountant's review and audit responsibilities should not follow management's responsibilities in the introductory paragraph.

QUESTION 333
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
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Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
There should be no comparison of the scope of a review to an audit in the second (scope) paragraph.

A. Correct
B. Incorrect

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Incorrect. There is and should be a comparison between a review and an audit in the scope paragraph.

QUESTION 334
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
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The financial statements for the year ended December 31, 20X1, were audited by us and our report was dated March 2, 20X2. We have no responsibility for updating that report for events and circumstances occurring after that date.
Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
Negative assurance should be expressed on the current year's reviewed financial statements in the second (scope) paragraph.

A. Correct
B. Incorrect

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Incorrect. The auditors should not express negative assurance or any degree of assurance in the second (scope) paragraph.

QUESTION 335
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
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The financial statements for the year ended December 31, 20X1, were audited by us and our report was dated March 2, 20X2. We have no responsibility for updating that report for events and circumstances occurring after that date.
Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
There should be a statement that no opinion is expressed on the current year's financial statements in the second (scope) paragraph.

A. Correct
B. Incorrect

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Correct. Because the auditors do substantially less work in a review than in an audit, the auditors should state that they do not express an opinion.

QUESTION 336
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
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Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
There should be a reference to "conformity with generally accepted accounting principles" in the third paragraph.

A. Correct
B. Incorrect

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Correct. There should be reference to conformity with generally accepted accounting principles in the third paragraph.

QUESTION 337
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of

Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
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The financial statements for the year ended December 31, 20X1, were audited by us and our report was dated March 2, 20X2. We have no responsibility for updating that report for events and circumstances occurring after that date.
Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
There should be no restriction on the use of the accountant's review report in the third paragraph.

A. Correct
B. Incorrect

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Correct. There should be no restriction on use in a review report.

QUESTION 338
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
Land, the engagement supervisor, decided not to reissue the prior year's auditors' report, but instructed Kent to include a separate paragraph in the current year's

review report describing the responsibility assumed for the prior year's audited financial statements. This is an appropriate reporting procedure.
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Accountant's Review Report
We have reviewed and audited the accompanying balance sheets of Tech Co. as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants and generally accepted auditing standards. All information included in these financial statements is the representation of the management of Tech Co.
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Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements. Because of the inherent limitations of a review engagement, this report is intended for the information of management and should not be used for any other purpose.
The financial statements for the year ended December 31, 20X1, were audited by us and our report was dated March 2, 20X2. We have no responsibility for updating that report for events and circumstances occurring after that date.
Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
There should be no reference to "material modifications" in the third paragraph.

A. Correct
B. Incorrect

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Incorrect. There should be a reference to the fact that the auditors are not aware of any material modifications that should be made (limited assurance).

QUESTION 339
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
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Accountant's Review Report
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The financial statements for the year ended December 31, 20X1, were audited by us and our report was dated March 2, 20X2. We have no responsibility for updating that report for events and circumstances occurring after that date.
Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
There should be an indication of the type of opinion expressed on the prior year's audited financial statements in the fourth (separate) paragraph.

A. Correct

B. Incorrect

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Correct. An example of such a separate paragraph is the following: "The financial statements for the year ended December 31, 20X1 were audited by us and we expressed an unqualified opinion on them in our report dated March 1, 20X2 but we have not performed any auditing procedures since that date."

QUESTION 340
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
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The financial statements for the year ended December 31, 20X1, were audited by us and our report was dated March 2, 20X2. We have no responsibility for updating that report for events and circumstances occurring after that date.
Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
There should be an indication that no auditing procedures were performed after the date of the report on the prior year's financial statements in the fourth (separate) paragraph.

A. Correct
B. Incorrect

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Correct. In the fourth paragraph, there should be an indication that the auditors performed no auditing procedures after the date of the report on the prior year's financial statements.

QUESTION 341
This question-consists of an item pertaining to possible deficiencies in an accountant's review report. Jordan & Stone, CPAs, audited the financial statements of Tech Co., a nonissuer, for the year ended December 31, 20X1, and expressed an unqualified opinion. For the year ended December 31, 20X2, Tech issued comparative financial statements. Jordan & Stone reviewed Tech's 20X2 financial statements and Kent, an assistant on the engagement, drafted the accountants' review report below.
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The financial statements for the year ended December 31, 20X1, were audited by us and our report was dated March 2, 20X2. We have no responsibility for updating that report for events and circumstances occurring after that date.
Jordan and Stone, CPAs March 1, 20X3
Supervisor's Review Notes
There should be no reference to "updating the prior year's auditor's report for events and circumstances occurring after that date" in the fourth (separate) paragraph.

A. Correct
B. Incorrect

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Correct. The report should not state that the auditors have no responsibility for updating the prior year's audit report for events and circumstances that occurred after that date. This type of comment is included in a report on prospective financial statements, not in a report on the financial statements of a nonissuer.

QUESTION 342
Which of the following is true about the term "likely misstatement?"

A. It refers to misstatements that have not been specifically identified, but which are likely to exist based on the auditor's judgment.
B. It refers to the cumulative effect of misstatements from prior years on the current year's financial statements.
C. It refers to misstatements that have been specifically identified by the auditor.
D. It includes both identified misstatements and an estimate of unidentified misstatements.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. A "likely misstatement" is one that has not been specifically identified, but which is likely to exist based on the auditor's judgment.
Choice "b" is incorrect. "Likely misstatement" does not refer to the cumulative effect of prior year errors.
It is a measure of misstatements the auditor considers likely to exist, that have not been specifically identified.
Choice "c" is incorrect. "Likely misstatement" is a measure of misstatements the auditor considers likely to exist, that have not been specifically identified.
Choice "d" is incorrect. The term "likely misstatement" includes only an estimate of potential errors. It does not include specific misstatements identified during the audit.

QUESTION 343
A successor auditor ordinarily should request to review the predecessor's audit documentation relating to:

	Contingencies	*Internal control*
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. A review of the predecessor's audit documentation related to matters of continuing accounting and auditing significance would be permitted. This would include documentation concerning contingencies and internal controls.
Choice "b" is incorrect. It is appropriate for the successor auditor to review the predecessor's audit documentation relating to internal controls.
Choice "c" is incorrect. It is appropriate for the successor auditor to review the predecessor's audit documentation relating to contingencies as they may have an impact on the current year financial statements. Choice "d" is incorrect. It is appropriate for the successor auditor to review the predecessor's audit documentation relating to internal controls and contingencies.

QUESTION 344
An auditor's engagement letter most likely would include:

A. Management's acknowledgment of its responsibility for maintaining effective internal control.
B. The auditor's preliminary assessment of the risk factors relating to misstatements arising from fraudulent financial reporting.
C. A reminder that management is responsible for illegal acts committed by employees.
D. A request for permission to contact the client's lawyer for assistance in identifying litigation, claims, and assessments.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. An understanding with the client should be established regarding management's responsibilities, which include establishing and maintaining effective internal control over financial reporting. This is generally documented in an engagement letter.
Choice "b" is incorrect. During the planning process, the auditor must document evidence of the assessment of the risk of material misstatement due to fraud. This information would be included in the audit documentation, not in the engagement letter.
Choice "c" is incorrect. Management is not responsible for illegal acts committed by employees, and therefore the engagement letter would not include such a statement.
Choice "d" is incorrect. The auditor generally does not contact the client's lawyer directly; rather, a letter is sent from management to the lawyer requesting corroboration of information related to litigation, claims, and assessments. The engagement letter therefore would not include a request for permission to contact the attorney.

QUESTION 345
Which of the following auditor concerns most likely could be so serious that the auditor concludes that a financial statement audit cannot be performed?

A. Management fails to modify prescribed internal controls for changes in information technology.
B. Internal control activities requiring segregation of duties are rarely monitored by management.
C. Management is dominated by one person who is also the majority stockholder.
D. There is a substantial risk of intentional misapplication of accounting principles.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:

Section: Volume B

Choice "d" is correct. Intentional misapplication of accounting principles would indicate that management lacks integrity and as a result, the auditor might conclude that a financial statement audit cannot be performed.
Choice "a" is incorrect. Management's failure to modify prescribed internal controls for changes in information technology would preclude the auditor from relying on those controls but would not prevent the auditor from performing a financial statement audit.
Choice "b" is incorrect. If management rarely monitors segregation of duties, the auditor would not rely on that particular control, but this would not prevent the auditor from performing a financial statement audit.
Choice "c" is incorrect. If management is dominated by one person who is also the majority stockholder, the risk of fraudulent financial reporting is increased, but this would not preclude the auditor from performing a financial statement audit.

QUESTION 346
Which of the following factors would a CPA ordinarily consider in the planning stage of an audit engagement?
I. Financial statement accounts likely to contain a misstatement.
II. Conditions that require extension of audit tests.

A. I only.
B. II only.
C. Both I and II.
D. Neither I nor II.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. During the planning stage, the auditor assesses the risk of material misstatement in financial statement accounts. Based on this assessment, the auditor plans the audit procedures to provide reasonable assurance that material misstatements in the financial statements will be detected. Additionally, during the planning stage, conditions may come to the auditor's attention that indicate a necessary extension of audit tests. The auditor would need to consider this factor in determining the time budget and staffing needs for the engagement.
Choices "a", "b", and "d" are incorrect. The auditor would need to consider both factors (financial statement accounts likely to contain a misstatement and conditions that require an extension of audit tests) in planning the audit.

QUESTION 347
In assessing the objectivity of internal auditors, the independent CPA who is auditing the entity's financial statements most likely would consider the:

A. Internal auditing standards developed by The Institute of Internal Auditors.

B. Tests of internal control activities that could detect errors and fraud.
C. Materiality of the accounts recently inspected by the internal auditors.
D. Results of the tests of transactions recently performed by the internal auditors.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. Objectivity is reflected by the organizational level to which the internal auditor reports as well as by policies prohibiting audits of areas where the internal auditor lacks independence.
In assessing the objectivity of internal auditors, the independent CPA who is auditing the entity's financial statements considers information obtained from previous experience, from discussions with management, from external quality reviews (if performed), and from professional internal auditing standards (such as those developed by The Institute of Internal Auditors).
Choice "b" is incorrect. Tests of internal control activities that could detect errors and fraud would not help the CPA assess the objectivity of the internal auditor.
Choice "c" is incorrect. The materiality of the accounts recently inspected by the internal auditors would not help the CPA assess the objectivity of the internal auditor.
Choice "d" is incorrect. Results of the tests of transactions recently performed by the internal auditor would aid the auditor in evaluating the internal auditor's competence rather than his or her objectivity.

QUESTION 348
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 operations and industry.
C. The CPA is unable to review the predecessor auditor's audit documentation.
D. The prospective client is unwilling to make all financial records available to the CPA.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. An auditor must consider the availability and adequacy of the client's accounting records and the integrity of management in deciding

whether or not to accept a new audit engagement. A prospective client that is unwilling to provide all financial records would give the auditor cause for concern about both of these issues.
Choice "a" is incorrect. The auditor may apply acceptable alternative procedures to audit inventory.
Choice "b" is incorrect. The auditor can accept the engagement and obtain an understanding of the client's operations and industry after acceptance.
Choice "c" is incorrect. Inability to review the predecessor's audit documentation means the auditor will expend greater effort auditing beginning balances. It does not mean the engagement should be declined.

QUESTION 349
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 this 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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. The AICPA's Accounting Trends & Techniques is an annual survey of accounting practices followed in 600 stockholders' annual reports.
Choices "a", "c", and "d" are incorrect. These sources do not provide comparative information about accounting practices.

QUESTION 350
Which of the following factors most likely would lead a CPA to conclude that a potential audit engagement should be rejected?

A. The details of most recorded transactions are not available after a specified period of time.
B. Internal control activities requiring the segregation of duties are subject to management override.
C. It is unlikely that sufficient appropriate evidence is available to support an opinion on the financial statements.
D. Management has a reputation for consulting with several accounting firms about significant accounting issues.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. A CPA cannot render an opinion on financial statements unless he or she has obtained sufficient appropriate audit evidence supporting that opinion. If such evidence were unlikely to be available, the CPA would most likely reject the potential audit engagement.
Choice "a" is incorrect. The auditor takes the availability of information into account when planning the audit, and would need to perform testing throughout the period, but this would not be cause for rejecting a potential audit engagement. Choice "b" is incorrect. The risk of management override is considered during planning and would not be cause for rejecting a potential audit engagement. Choice "d" is incorrect. Management may consult with several accounting firms, and this would not be cause for rejecting a potential audit engagement.

QUESTION 351
Which of the following factors most likely would 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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. The control environment is the foundation for all other components of internal control. Management's disregard of its responsibility to maintain an adequate internal control environment therefore compromises its ability to provide reasonable assurance regarding reliable financial reporting. The auditor may conclude that the risk of misrepresentation in the financial statements is great enough that an audit should not be conducted.
Choice "a" is incorrect. The CPA does not need to understand the internal auditor's techniques in order to accept a new audit engagement.
Choice "c" is incorrect. Related party transactions (by definition) are not considered to be arm's-length transactions, and evaluation of such transactions does not affect the CPA's decision regarding acceptance of new clients. Choice "d" is incorrect. Substantive tests are generally performed after year-end, since prior to that time the financial statements have not been finalized.

QUESTION 352
Which of the following matters generally is included in an auditor's engagement letter?

A. Management's responsibility for the entity's compliance with laws and regulations.
B. The factors to be considered in setting preliminary judgments about materiality.

C. Management's vicarious liability for illegal acts committed by its employees.
D. The auditor's responsibility to search for significant internal control deficiencies.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. An understanding with the client should be established regarding management's responsibilities, which include identifying and ensuring that the entity complies with applicable laws and regulations. The understanding should be documented through a written communication, such as an engagement letter.
Choice "b" is incorrect. Judgments about materiality are the auditor's responsibility and would not be included in an engagement letter.
Choice "c" is incorrect. Management would not necessarily be responsible for illegal acts committed by employees. Choice "d" is incorrect. The auditor is not responsible for searching for significant internal control deficiencies.

QUESTION 353
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 representation 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.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Inquiry of the predecessor auditor is a required pre-acceptance procedure.
However, consent of the prospective client must be obtained before a CPA can make such inquiries of the predecessor auditor.
Choice "a" is incorrect. Obtaining an understanding of the client's industry and business is a planning procedure performed after an engagement is accepted.
Choice "b" is incorrect. A management representation letter is not obtained until the end of the audit.
Choice "c" is incorrect. Obtaining a preliminary understanding of the client's control environment is an audit procedure (required by the second standard of fieldwork) that would be performed after an engagement is accepted.

QUESTION 354
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.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. When assessing the internal auditors' objectivity, the auditor should obtain information about whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors.
Choice "a" is incorrect. A quality control program would impact the competence of the internal audit staff, not their objectivity.
Choice "b" is incorrect. Examining documentary evidence produced by the internal auditors would help the auditor evaluate the quality and effectiveness of the internal auditors' work, but would not help assess objectivity.
Choice "c" is incorrect. Testing a sample of transactions and balances examined by the internal auditors would help the auditor evaluate the quality and effectiveness of the internal auditors' work, but would not help assess objectivity.

QUESTION 355
Which of the following auditor concerns most likely could be so serious that the auditor concludes that a financial statement audit cannot be conducted?

A. The entity has no formal written code of conduct.
B. The integrity of the entity's management is suspect.
C. Procedures requiring segregation of duties are subject to management override.
D. Management fails to modify prescribed controls for changes in conditions.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Serious concerns about the integrity of management may indicate a risk of management misrepresentation in the financial statements that is so great that an audit cannot be conducted. If the integrity of management is suspect, there would be a presumption of dishonesty. The auditor would then need to question-the genuineness of all records and documents obtained from the client and would require conclusive rather than persuasive evidence to corroborate all management representations. An audit conducted on these terms would be unreasonably costly and impractical.
Choice "a" is incorrect. A formal written code of conduct is generally considered a positive control, but the lack of one would not preclude an audit from being conducted.
Choice "c" is incorrect. Management override of internal controls (such as segregation of duties) is an inherent limitation of any internal control and would not prevent an audit from being performed.
Choice "d" is incorrect. A failure by management to modify prescribed controls for changes in conditions may increase control risk, but since the auditor can generally compensate for weak internal controls with increased substantive testing, this would not preclude an audit.

QUESTION 356
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 Ill only.
D. I, II, and III.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The internal auditors' work may affect the nature, timing, and extent of the audit, including procedures the auditor performs when obtaining an understanding of the entity's internal control, when assessing risk, and when performing substantive procedures.
Choice "a" is incorrect. It is likely that many procedures performed by internal auditors will affect the independent auditor's substantive testing, by providing direct evidence about material misstatements in assertions.
Choice "b" is incorrect. It is likely that the work of internal auditors will aid the independent auditor in assessing control risk, since so much of the internal auditors' function is involved with monitoring the control structure.
Choice "c" is incorrect. It is very likely that the work of internal auditors will affect the independent auditor's procedures for obtaining an understanding of internal control, because monitoring the control system is the primary responsibility of the internal auditors. Their flowcharts, narratives, and analyses of controls could be helpful to the independent auditor.

QUESTION 357
Which of the following statements is correct concerning an auditor's use of the work of a specialist?

A. The auditor need not obtain an understanding of the methods and assumptions used by the specialist.
B. The auditor may not use the work of a specialist in matters material to the fair presentation of the financial statements.
C. The reasonableness of the specialist's assumptions and their applications are strictly the auditor's responsibility.
D. The work of a specialist who has a contractual relationship with the client may be acceptable under certain circumstances.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The purpose of using the work of a specialist is to provide the auditor with specialized skill or knowledge the auditor may lack. The work of a specialist who has a relationship with a client may be acceptable under certain circumstances. If the specialist has a relationship with the client, the auditor should assess the risk that the specialist's objectivity might be impaired. If the auditor believes that the relationship might impair the specialist's objectivity, the auditor should perform additional procedures with respect to the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should engage another specialist for that purpose.
Choice "a" is incorrect. Although the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of the methods or assumptions used in order to determine whether the findings are suitable for corroborating the representations in the financial statements.
Choice "b" is incorrect. The auditor may use, and in fact is encouraged to use, the work of a specialist in matters material to the fair presentation of the financial statements.
Choice "c" is incorrect. The appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist; the auditor should, however, obtain an understanding of the methods or assumptions used in order to determine whether the findings are suitable for corroborating the representations in the financial statements.

QUESTION 358
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.

Correct Answer: D
Section: Volume B

Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. In order to observe the physical inventory count, the auditor would have to coordinate schedules with the client. This timing is usually agreed upon before implementation of the audit strategy.
Choice "a" is incorrect. It would not be appropriate for the client to be involved in determining the amount of evidence necessary to provide a basis for an opinion.
Choice "b" is incorrect. It would not be appropriate for the client to be involved in determining the procedures necessary to obtain evidence about litigation, claims and assessments.
Choice "c" is incorrect. Determination of the pending legal matters to be included in a letter to the client's attorney would not generally be made during the planning stage of the audit.

QUESTION 359
A successor auditor most likely would make specific inquiries of the predecessor auditor regarding:

A. Specialized accounting principles of the client's industry.
B. The competency of the client's internal audit staff.
C. The uncertainty inherent in applying sampling procedures.
D. Disagreements with management as to auditing procedures.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Inquiries should include specific questions regarding, among other things, facts that might bear on the integrity of management; disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters; communications with those charged with governance regarding fraud, illegal acts, and matters relating to internal control; and the predecessor's understanding as to the reasons for the change of auditors. Choice "a" is incorrect. Specialized industry accounting principles might be discussed; however, the successor would be more likely to inquire about items specific to the client.
Choice "b" is incorrect. The competency of the client's internal audit staff might be discussed; however, inquiries of the predecessor auditor regarding the staff are not required. Choice "c" is incorrect. The uncertainty in applying sampling procedures is not something that is typically discussed with the predecessor auditor.

QUESTION 360

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

A. Fees for our services are based on our regular per diem rates, plus travel and other out-of-pocket expenses.
B. 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 errors or fraud, including defalcations, if they exist, will not be detected.
D. After performing our preliminary analytical procedures we will discuss with you the other procedures we consider necessary to complete the engagement.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The auditor does not consult with the client about audit procedures that will be performed.
Choice "a" is incorrect. Since the engagement letter serves as a contract between the auditor and client, fee arrangements are typically disclosed in the letter.
Choice "b" is incorrect. A discussion regarding possible auditor suggestions is appropriate for inclusion in an engagement letter.
Choice "c" is incorrect. The fact that audit risk exists and that an audit only provides reasonable assurance of the detection of errors and fraud is typically disclosed in an engagement letter.

QUESTION 361
Which of the following procedures would an auditor most likely perform in planning a financial statement audit?

A. Inquiring of the client's legal counsel concerning pending litigation.
B. Comparing the financial statements to anticipated results.
C. Examining computer generated exception reports to verify the effectiveness of internal controls.
D. Searching for unauthorized transactions that may aid in detecting unrecorded liabilities.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. A requirement during planning is to perform analytical procedures, which involve comparisons of recorded amounts to expectations.
Choice "a" is incorrect. Inquiry of the client's legal counsel is typically performed near the end of fieldwork.
Choice "c" is incorrect. Tests of controls are performed after audit planning is complete.

Choice "d" is incorrect. The search for unrecorded liabilities is generally performed at or after year-end.

QUESTION 362
The in-charge auditor most likely would have a supervisory responsibility to explain to the staff assistants:

A. That fraud is not to be reported to those charged with governance.
B. How the results of various auditing procedures performed by the assistants should be evaluated.
C. What benefits may be attained by the assistants' adherence to established time budgets.
D. Why certain documents are being transferred from the current file to the permanent file.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Assistants should be informed of their responsibilities and the objectives of the procedures that they are to perform. Part of the assistant's responsibility is to properly evaluate audit results, and the in-charge auditor would likely discuss this with them.
Choice "a" is incorrect. Fraud that causes a material misstatement or involves senior management should be reported to those charged with governance.
Choice "c" is incorrect. Preparation and maintenance of the time budget is related to planning rather than supervision.
Choice "d" is incorrect. The reasons for transferring documents from the permanent file to the current file need not be explained to the staff assistants.

QUESTION 363
Analytical procedures used in planning an audit should focus on:

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

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Analytical procedures used in planning the audit should focus on enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date. Choice "a" is incorrect. Analytical procedures used in planning do not reduce tests of controls or substantive tests.
Choice "b" is incorrect. Analytical procedures used in planning are not designed to identify material misstatements.
Choice "d" is incorrect. Audit evidence has not yet been gathered during the planning process, so its adequacy cannot be assessed.

QUESTION 364
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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. An illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.
Choice "b" is incorrect. Failure to retire a piece of obsolete office equipment is not likely to have ramifications beyond the immaterial misstatement that would result directly from it.
Choice "c" is incorrect. Failure to properly authorize a petty cash fund disbursement is not likely to have ramifications beyond the immaterial misstatement that would result directly from it.
Choice "d" is incorrect. Failure to write off a relatively small uncollectible account receivable is not likely to have ramifications beyond the immaterial misstatement that would result directly from it.

QUESTION 365
Which of the following risks 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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Both the risk of material misstatement (including control risk and inherent risk) and detection risk may be assessed in quantitative terms such as percentages or in nonquantitative terms that range, for example, from a minimum to a maximum.
Choices "a", "b", and "d" are incorrect, based on the above explanation.

QUESTION 366
Which of the following would an auditor most likely use in determining the auditor's preliminary judgment about materiality?

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

Correct Answer: B
Section: Volume B

Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. The auditor's preliminary judgment about materiality is generally based on either annualized interim financial statements or annual financial statements from a prior period.
Choice "a" is incorrect. The anticipated sample size for substantive tests is irrelevant in making a preliminary judgment about materiality.
Choice "c" is incorrect. The results of the internal control questionnaire would be relevant for making a preliminary assessment of control risk; however, these results are irrelevant for determining a preliminary level of materiality.
Choice "d" is incorrect. The management representation letter is obtained at the end of the audit and would not be available when preliminary assessments of materiality are made during planning.

QUESTION 367
An auditor should design the written 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.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. An audit plan aids in instructing assistants in the work to be done. It should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit. Choice "a" is incorrect. Auditors make extensive use of sampling to perform audit tests. Tests of all material transactions would not be economically feasible.
Choice "b" is incorrect. Assuming that incremental risk can be controlled, substantive tests can be performed prior to year-end.
Choice "d" is incorrect. An account balance does not necessarily have to have tests of controls or tests of transactions applied to it.

QUESTION 368
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:

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

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. If, during the audit, the successor auditor becomes aware of information indicating that the financial statements reported on by the predecessor auditor may require revision, he or she should request the client to arrange a meeting among the three parties to discuss the information and attempt to resolve the matter.
Choice "a" is incorrect. It is not the successor auditor's responsibility to inform readers that the financial statements, which were audited by another firm, cannot be relied upon.
Choice "b" is incorrect. The prior year's financial statements should not be reissued until the two auditing firms and the client have an opportunity to discuss the matter. There is a reasonable likelihood that the successor firm is unaware of other information that supports the current condition of the prior year financial statements.
Choice "c" is incorrect. The successor firm should not notify the predecessor directly but should request that the client do so.

QUESTION 369
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.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. In making judgments about the extent of the effect of the internal auditor's work on the auditor's procedures, the auditor considers the materiality of financial statement amounts, the risk of material misstatement of the assertions related to these financial statement amounts, and the degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the assertions. As the degree of subjectivity increases, the need for the auditor to perform tests of the assertions increases.
Testing the existence of fixed asset additions involves very little subjectivity, and thus work performed by the internal auditor may reduce the auditor's testing in this area.
Choice "a" is incorrect. Testing the existence of contingencies involves much subjectivity, and should, therefore, be performed by the auditor.
Choice "b" is incorrect. Testing the valuation of intangible assets involves much subjectivity, and should, therefore, be performed by the auditor.
Choice "d" is incorrect. Testing the valuation of related party transactions involves much subjectivity, and should, therefore, be performed by the auditor.

QUESTION 370
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Internal auditors may assist the auditor in obtaining an understanding of internal control and in performing tests of controls and substantive tests. Choices "a", "b", and "c" are incorrect, based on the above explanation.

QUESTION 371
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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. The work of a specialist who has a relationship with a client may be acceptable under certain circumstances. If the specialist is related to the client, the auditor should consider performing additional procedures with respect to the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable, or should engage another specialist for that purpose.
Choice "b" is incorrect. If the auditor believes the findings are unreasonable, the auditor should apply additional procedures, which may include obtaining the opinion of another specialist. This does not imply that there is a problem with the financial statements, and therefore would not necessarily result in a qualified opinion.
Choice "c" is incorrect. If there is a material difference between a specialist's findings and the assertions in the financial statements, and if the specialist's findings are deemed reasonable, either a qualified or an adverse opinion may be issued. (Note that it is also possible that the specialist's findings turn out to be erroneous, in which case an unqualified opinion might be issued.) Choice "d" is incorrect. A specialist may be used to determine the physical characteristics relating to inventory (e.g., quantity on hand or condition).

QUESTION 372
In using the work of a specialist, an auditor of a nonissuer 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.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to the auditor's standard report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.
Choice "b" is incorrect. The auditor should not refer to the work or findings of the specialist unless the specialist's work results in a change to the auditor's report.
Choice "c" is incorrect. The auditor should not refer to the work or findings of the specialist unless the specialist's work results in a change to the auditor's report.
Choice "d" is incorrect. The identification of significant deficiencies in the design of the client's internal control would not result in a change to the auditor's report. The auditor should not refer to the work or findings of the specialist unless the specialist's work results in a change to the auditor's report.

QUESTION 373
Which of the following procedures would an auditor most likely include in the initial planning of a financial statement audit?

A. Obtaining a written representation letter from the client's management.
B. Examining documents to detect illegal acts having a material effect on the financial statements.
C. Considering whether the client's accounting estimates are reasonable in the circumstances.
D. Determining the extent of involvement of the client's internal auditors.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The auditor considers several factors in planning the nature, timing and extent of auditing procedures. One of these factors is the extent of involvement of the client's internal auditors. Choice "a" is incorrect. Representation letters are obtained by the auditor at the end of the audit. The representation letter should not be dated earlier than the date of the auditor's report.
Choice "b" is incorrect. The auditor does not perform tests to detect illegal acts during the planning process.
Choice "c" is incorrect. The auditor does obtain and evaluate evidence to support significant accounting estimates, but this occurs subsequent to initial planning.

QUESTION 374
Which of the following factors most likely would influence an auditor's determination of the auditability of an entity's financial statements?

A. The complexity of the information system relevant to financial reporting.
B. The existence of related party transactions.
C. The adequacy of the accounting records.

D. The operating effectiveness of controls.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Inadequate financial records may preclude the auditor from obtaining sufficient appropriate audit evidence.
Choice "a" is incorrect. The complexity of the client's information system generally would not influence an auditor's determination of auditability, although it might indicate the need for an information technology expert. Choice "b" is incorrect. The existence of related party transactions generally would not influence the auditor's determination of auditability. Choice "d" is incorrect. The operating effectiveness of internal controls is determined long after the decision about auditability is made.

QUESTION 375
Hill, CPA, has been retained to audit the financial statements of Monday Co. Monday's predecessor auditor was Post, CPA, who has been notified by Monday that Post's services have been terminated.
Under these circumstances, which party should initiate the communications between Hill and Post?

A. Hill, the successor auditor.
B. Post, the predecessor auditor.
C. Monday's controller or CFO.
D. The chairman of Monday's board of directors.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. The initiative to communicate with the predecessor auditor rests with the successor auditor. Note, however, that the successor auditor must first receive permission from the client.
Choice "b" is incorrect. The predecessor auditor should respond promptly and fully to reasonable inquiries. However, the predecessor is not responsible for initiating communications.
Choice "c" is incorrect. The prospective client should authorize the predecessor to respond fully to the successor's inquiries. However, the client is not responsible for initiating communications.

Choice "d" is incorrect. The prospective client should authorize the predecessor to respond fully to the successor's inquiries. However, the client is not responsible for initiating communications.

QUESTION 376
The senior auditor responsible for coordinating the fieldwork usually schedules a pre-audit conference with the audit team primarily to:

A. Give guidance to the staff regarding both technical and personnel aspects of the audit.
B. Discuss staff suggestions concerning the establishment and maintenance of time budgets.
C. Establish the need for using the work of specialists and internal auditors.
D. Provide an opportunity to document staff disagreements regarding technical issues.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. Pre-audit planning meetings are typically held to plan technical and personnel aspects of the audit. Assistants should be informed of their responsibilities and the objectives of the procedures that they are to perform. Choice "b" is incorrect. While staff suggestions regarding time budgets may be discussed, this is not typically the primary reason for the meeting.
Choice "c" is incorrect. Establishing the need for specialists and internal auditors may be discussed, but this is not the primary reason for the meeting. Choice "d" is incorrect. Disagreements about technical issues arise and are resolved after testing begins, not during the pre-audit conference.

QUESTION 377
To obtain an understanding of a continuing client's business in planning an audit, an auditor most likely would:

A. Perform tests of details of transactions and balances.
B. Review prior-year audit documentation and the permanent file for the client.
C. Read specialized industry journals.
D. Reevaluate the client's internal control environment.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Knowledge of an entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of personnel of the entity. Audit documentation from prior years may contain useful information about the nature of the business, its organizational structure, its operating characteristics, and transactions that may require special consideration.
Choice "a" is incorrect. Tests of details of transactions and balances are not performed during the planning stage of an audit.
Choice "c" is incorrect. Reading industry journals would provide information about the industry in which the entity operates, but reviewing prior-year audit documentation and the permanent file would provide a more thorough understanding of the specific client's business.
Choice "d" is incorrect. The client's internal control is not reevaluated during the planning stage of an audit.

QUESTION 378
In planning an audit of a new client, an auditor most likely would consider the methods used to process accounting information because such methods:

A. Influence the design of internal control.
B. Affect the auditor's preliminary judgment about materiality levels.
C. Assist in evaluating the planned audit objectives.
D. Determine the auditor's acceptable level of audit risk.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. The auditor should consider the methods the entity uses to process accounting information in planning the audit because such methods influence the design of internal control. The extent to which computer processing is used in significant accounting applications, as well as the complexity of the processing, may also influence the nature, timing, and extent of audit procedures.
Choice "b" is incorrect. Materiality is a matter of professional judgment and is influenced by the auditor's perceptions of the needs of a reasonable person. It would not be affected by the methods used to process accounting information.
Choice "c" is incorrect. The auditor develops specific audit objectives based on financial statement assertions. The methods used to process accounting information would not be relevant to the development of objectives.
Choice "d" is incorrect. Audit risk is the risk that the auditor may unknowingly fail to modify the opinion on financial statements that are materially misstated. The acceptable level of audit risk is a matter of auditor judgment, but it would not be affected by the methods used to process accounting information.

QUESTION 379
The existence of audit risk is recognized by the statement in the auditor's standard report that the:

A. Auditor is responsible for expressing an opinion on the financial statements, which are the responsibility of management.

B. Financial statements are presented fairly, in all material respects, in conformity with GAAP.
C. Audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
D. Auditor obtains reasonable assurance about whether the financial statements are free of material misstatement.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The existence of audit risk is recognized by the statement in the standard report that the auditor obtained reasonable assurance about whether the financial statements are free of material misstatement. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated.
Choice "a" is incorrect. This statement defines the distinction between the responsibility of the auditor and that of management.
Choice "b" is incorrect. The purpose of this section is to note that fair presentation is not necessarily impacted by immaterial errors. Choice "c" is incorrect. This statement explains the nature of an audit.

QUESTION 380
Which of the following statements is not correct about materiality?

A. 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.
B. 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.
C. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative judgments.
D. 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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Materiality levels include an overall level for each statement; however, because the statements are interrelated, and for reasons of efficiency, the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatements that could be considered

material to any one of the financial statements.
Choice "a" is incorrect. The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for the fair presentation of financial statements in conformity with GAAP, while other matters are not important.
Choice "c" is incorrect. Materiality judgments are made in light of the surrounding circumstances and necessarily involve both quantitative and qualitative considerations.
Choice "d" is incorrect. The auditor's consideration of materiality is influenced by his or her perception of the needs of a reasonable person relying on the financial statements.

QUESTION 381
Which of the following documentation is not required for an audit in accordance with generally accepted auditing standards?

A. A written audit plan setting forth the procedures necessary to accomplish the audit's objectives.
B. An indication that the accounting records agree or reconcile with the financial statements.
C. A client engagement letter that summarizes the timing and details of the auditor's planned fieldwork.
D. The basis for the auditor's decision not to perform tests of controls concurrently with obtaining an understanding of internal control.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The auditor is not required to evaluate operating effectiveness as part of obtaining an understanding of internal control, and therefore need not document the basis for this decision. Choice "a" is incorrect. The auditor is required to prepare a written audit plan.
Choice "b" is incorrect. Audit documentation should be sufficient to show that the accounting records agree or reconcile with the financial statements.
Choice "c" is incorrect. Establishing an understanding with the client is required by GAAS, and an engagement letter is a presumptively mandatory requirement.

QUESTION 382
When assessing the internal auditors' 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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. When assessing the internal auditors' competence, the auditor should obtain information about such factors as educational level, experience, professional certification, continuing education, supervision, review, and evaluation of performance.
Choice "a" is incorrect. The organizational level to which the internal auditors report is related to their objectivity.
Choice "c" is incorrect. Policies prohibiting internal auditors from auditing areas where relatives are employed are related to objectivity.
Choice "d" is incorrect. Access to sensitive records and information is related to the overall objectives of the internal audit function, not to internal auditor competence.

QUESTION 383
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.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Although the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of the methods or assumptions used in order to determine whether the findings are suitable for corroborating the representations in the financial statements.
Choice "a" is incorrect. An understanding should exist among the auditor, the client, and the specialist as to the nature of the work to be performed.
Choice "b" is incorrect. The auditor may consider performing substantive procedures to verify the specialist's findings if the specialist is related to the client, but is not required to do so. Choice "c" is incorrect. An understanding should exist among the auditor, the client, and the specialist as to the nature of the work to be performed.

QUESTION 384
In assessing the competence and objectivity of an entity's internal auditor, an independent auditor least likely would 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.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. Analytical procedures may be used to enhance the auditor's understanding of the client's business or to evaluate financial statement assertions, but generally would not be helpful in assessing the competence and objectivity of an entity's internal auditor.
Choice "a" is incorrect. In assessing competence and objectivity, the auditor usually considers information obtained from discussions with management personnel.
Choice "b" is incorrect. In assessing competence and objectivity, the auditor usually considers information obtained from external quality reviews of internal audit activities.
Choice "c" is incorrect. In assessing competence and objectivity, the auditor usually considers information obtained from previous experience with the internal audit function.

QUESTION 385
Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding the predecessor's:

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

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Before accepting an engagement, the auditor should make specific inquiries of the predecessor auditor in order to assist the auditor in deciding whether or not to accept the engagement. Inquiry should include the predecessor's understanding of the reasons for the change in auditors.
Choice "a" is incorrect. The predecessor generally does not provide an opinion on events occurring subsequent to the issuance of the audit report.

Choice "c" is incorrect. The successor (and not the predecessor) evaluates the consistency in the application of GAAP. This evaluation occurs after acceptance.
Choice "d" is incorrect. The predecessor generally allows the successor to review audit documentation related to matters of continuing accounting significance, but this occurs subsequent to acceptance.

QUESTION 386
Which of the following factors most likely would cause an auditor not to accept a new audit engagement?

A. An inadequate understanding of the entity's internal control.
B. The close proximity to the end of the entity's fiscal year.
C. Concluding that the entity's management probably lacks integrity.
D. An inability to perform preliminary analytical procedures before accepting the engagement.

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. A conclusion that management lacks integrity would probably cause the auditor not to accept a new engagement.
Choice "a" is incorrect. Inadequate understanding of the client's internal control would not prevent the auditor from accepting the engagement, since that understanding could be obtained later.
Choice "b" is incorrect. Proximity to year-end would not prevent an auditor from accepting a new audit engagement.
Choice "d" is incorrect. While analytical procedures are required during planning, this generally occurs subsequent to accepting the engagement.

QUESTION 387
The audit work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the:

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

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:

Section: Volume B

Choice "b" is correct. Review of assistants' work is necessary to determine whether it was performed in a satisfactory manner and to determine whether the work supports the conclusions presented in the auditor's report.
Choice "a" is incorrect. The responsibility of a firm to establish review procedures (a system of quality control) is distinct from the auditor's responsibility to adequately plan and supervise the work on a particular engagement. Quality control standards relate to the conduct of the firm's audit practice as a whole; GAAS relates to the conduct of individual audits.
Choice "c" is incorrect. Specific audit procedures are performed based on the auditor's judgment and would not necessarily be approved in the professional standards.
Choice "d" is incorrect. Review of an assistant's work would not necessarily be indicative of that assistant's technical training and proficiency. The review process is to determine whether the audit is being performed in a satisfactory manner.

QUESTION 388
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.

Correct Answer: D
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The auditor should obtain knowledge of the client's business and its industry in order to determine the effect of transactions, events, and practices on the client's financial statements.
Choice "a" is incorrect. Constructive suggestions concerning improvements in the new client's internal control are generally made after the study and evaluation of the client's internal control, performed subsequent to planning. Knowledge about the new client's business and its industry is generally obtained during planning.
Choice "b" is incorrect. The auditor should have an attitude of professional skepticism in conducting the engagement, but this attitude is not necessarily related to the auditor's knowledge of the new client's business and its industry.
Choice "c" is incorrect. The auditor should evaluate whether the aggregation of known misstatements materially affects the financial statements, but this is done near the audit's conclusion. Knowledge about the new client's business and its industry is generally obtained during planning.

QUESTION 389
The objective of performing analytical procedures in planning an audit is to identify the existence of:

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

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. The objective of performing analytical procedures during planning is to discover unusual transactions or events that may have an impact on the planning of the financial statement audit. Choice "b" is incorrect. Analytical procedures are not effective in identifying illegal acts that went undetected due to internal control weaknesses.
Choice "c" is incorrect. Analytical procedures are not effective in identifying related party transactions.
Choice "d" is incorrect. Analytical procedures are not effective as tests of controls to identify unauthorized transactions.

QUESTION 390
Which of the following is required documentation in an audit in accordance with generally accepted auditing standards?

A. A flowchart or narrative of the information system relevant to financial reporting describing the recording and classification of transactions for financial reporting.
B. An audit plan setting forth in detail the procedures necessary to accomplish the engagement's objectives.
C. A planning memorandum establishing the timing of the audit procedures and coordinating the assistance of entity personnel.
D. An internal control questionnaire identifying controls that assure specific objectives will be achieved.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. In an audit conducted in accordance with GAAS, the auditor must document the audit plan, setting forth in detail the procedures necessary to accomplish the engagement's objectives.

Choice "a" is incorrect. Documentation of the auditor's understanding of the client's internal control is required, but may take different forms. A narrative, an internal control questionnaire, a flowchart, or simply a memorandum (for a small client) may be sufficient.
Choice "c" is incorrect. A planning memo, while recommended, is not required under GAAS.
Choice "d" is incorrect. Documentation of the auditor's understanding of the client's internal control is required, but may take different forms: narrative, internal control questionnaire, flowchart, or simply a memorandum (for a small client) may be sufficient. In addition, controls do not assure the achievement of objectives.

QUESTION 391
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. Auditor understands the form and content 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.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. When expressing an unqualified opinion, the auditor generally will not refer to the work or findings of a specialist. The auditor may, however, make reference to a specialist in an explanatory paragraph if such a reference will facilitate understanding of the explanatory paragraph or of the departure from an unqualified opinion.
Choice "a" is incorrect. Lack of client familiarity with the specialist does not affect the auditor's report. Also, it is the auditor (not the client) who must be satisfied regarding the specialist's qualifications.
Choice "c" is incorrect. The auditor must understand the form and content of the specialist's findings in relation to the representations in the financial statements to be able to review the specialist's work. However, this does not affect whether or not the auditor refers to the specialist in the auditor's report.
Choice "d" is incorrect. An auditor should not divide responsibility for the audit with a specialist. Further, making reference to the specialist in an unmodified unqualified report generally is inappropriate.

QUESTION 392
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 the details of the disagreement with the conclusion reached.

C. Discuss the disagreement with the entity's management or its audit committee.
D. Report the disagreement to an impartial peer review monitoring team.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. Each assistant has a professional responsibility to bring to the attention of appropriate individuals in the firm, disagreements or concerns the assistant might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or auditor's report. In addition, each assistant should have a right to document his or her disagreement if he or she believes it is necessary to be disassociated from the resolution of the matter.
Choice "a" is incorrect. Quality control committees are primarily concerned with determining whether quality control policies and procedures are being effectively applied. Generally, they would not get involved with disagreements related to specific engagements.
Choice "c" is incorrect. Disagreements among an audit firm's staff would generally be handled internally. Discussion of such matters with the client would be inappropriate.
Choice "d" is incorrect. Impartial peer review teams are primarily concerned with determining whether quality control policies and procedures are being effectively applied. Generally, they would not get involved with disagreements related to specific engagements.

QUESTION 393
Before accepting an engagement to audit a new client, an auditor is required to:

A. Make inquiries of the predecessor auditor after obtaining the consent of the prospective client.
B. Obtain an understanding of the entity and its environment, including its internal control.
C. Prepare a memorandum setting forth the staffing requirements and documenting the preliminary audit plan.
D. Discuss the management representation letter with the prospective client's audit committee.

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. Prior to acceptance of a new engagement, an auditor must attempt to communicate with the predecessor auditor. Inquiry is important

because the predecessor auditor may provide information critical to the acceptance decision. Under the Rules of the Code of Professional Conduct, the auditor must first request the client's permission.
Choice "b" is incorrect. Although the auditor is required to obtain an understanding of the entity and its environment, including its internal control, this typically happens after the engagement is accepted, not before. Choice "c" is incorrect. A planning memo setting forth staff requirements and documenting the preliminary audit plan is usually prepared after accepting an engagement. Choice "d" is incorrect. A management representation letter is usually obtained at the conclusion of the audit and is dated as of the date of auditor's report.

QUESTION 394
In considering materiality for planning purposes, an auditor believes that misstatements aggregating $10,000 would have a material effect on an entity's income statement, but that misstatements would have to aggregate $20,000 to materially affect the balance sheet. Ordinarily, it would be appropriate to design auditing procedures that would be expected to detect misstatements that aggregate:

A. $10,000
B. $15,000
C. $20,000
D. $30,000

Correct Answer: A
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "a" is correct. Because the statements are interrelated, the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatement that could be considered material to any one of the financial statements.
Choices "b", "c", and "d" are incorrect, based on the above explanation.

QUESTION 395
Analytical procedures used in planning an audit should focus on:

A. Evaluating the adequacy of evidence gathered concerning unusual balances.
B. Testing individual account balances that depend on accounting estimates.
C. Enhancing the auditor's understanding of the client's business.
D. Identifying material weaknesses in internal control.

Correct Answer: C
Section: Volume B

Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain audit evidence for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (a) enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date, and (b) identifying areas that may represent specific risks relevant to the audit.
Choice "a" is incorrect. Analytical procedures to assess the adequacy of evidence would be used in the final review stage.
Choice "b" is incorrect. Testing individual account balances that depend on accounting estimates would be a substantive application of analytical procedures and would not be used in the planning stages of an audit. Choice "d" is incorrect. Analytical procedures are generally not useful in detecting material weaknesses in the client's internal control.

QUESTION 396
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?

	Materiality of misstatements	Evaluation of accounting estimates
A.	Yes	No
B.	No	Yes
C.	No	No
D.	Yes	Yes

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Because the auditor has the ultimate responsibility to express an opinion on the financial statements, judgments about assessments of risk, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the auditor. Choices "a", "b", and "d" are incorrect, based on the above explanation.

QUESTION 397
Which of the following procedures would an auditor least likely perform in planning a financial statement audit?

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

Correct Answer: C
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "c" is correct. Selecting a sample of vendors' invoices for comparison to receiving reports is performed during fieldwork. This is not part of the planning phase.
Choice "a" is incorrect. Coordinating the assistance of entity personnel in data preparation is usually performed during the planning phase.
Choice "b" is incorrect. During the planning phase, matters that may affect the audit should be discussed with firm personnel responsible for non-audit services to the entity. Choice "d" is incorrect. During the planning phase, the auditor generally would read the current year's interim financial statements.

QUESTION 398
When assessing an internal auditor's competence, a CPA ordinarily obtains information about all of the following, except:

A. Quality of audit documentation.
B. Educational level and professional experience.
C. The audit plan and audit procedures.
D. Access to information about related parties.

Correct Answer: D

Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "d" is correct. The degree of access the independent auditor has to information about related parties provides no information regarding an internal auditor's competence.
Choice "a" is incorrect. In evaluating the work of internal auditors, the independent auditor should examine, on a test basis, documentary evidence of the work performed by internal auditors and should consider such factors as whether the scope of the work is appropriate, the audit plan is adequate, audit documentation adequately documents work performed, conclusions reached are appropriate in the circumstances, and any reports prepared are consistent with the results of the work performed.
Choice "b" is incorrect. When considering the competence of internal auditors, the independent auditor should inquire about the qualifications of the internal audit staff, including for example, consideration of the client's practices for hiring, training, and supervising internal audit staff. This includes inquiries as to the internal auditor's educational level and professional experience.
Choice "c" is incorrect. In evaluating the work of internal auditors, the independent auditor should examine, on a test basis, documentary evidence of the work performed by internal auditors and should consider such factors as whether the scope of the work is appropriate, the audit plan is adequate, audit documentation adequately documents work performed, conclusions reached are appropriate in the circumstances, and any reports prepared are consistent with the results of the work performed.

QUESTION 399
When an auditor increases the assessed level of control risk because certain control activities were determined to be ineffective, the auditor most likely would increase the:

A. Level of detection risk.
B. Extent of tests of details.
C. Level of inherent risk.
D. Extent of tests of controls.

Correct Answer: B
Section: Volume B
Explanation

Explanation/Reference:
Section: Volume B

Choice "b" is correct. An increase in the assessed level of control risk means that the assessed risk of material misstatement has also increased, and this requires a corresponding decrease in detection risk to maintain the same (presumably low) level of overall audit risk. Increasing the extent of tests of details will result in a reduction in detection risk.

Choice "a" is incorrect. Increasing detection risk would result in a corresponding increase in overall audit risk, which is the opposite of the desired response.
Choice "c" is incorrect. The auditor cannot change the level of inherent risk, which is based on the nature of the related assertion.
Choice "d" is incorrect. If the auditor has already determined that certain control activities are ineffective, increasing the extent of those tests is not likely to be helpful. The auditor needs to find a way to compensate for the increased level of risk in order to keep overall audit risk to a low level.

QUESTION 400
A CPA wishes to determine how various publicly-held companies have complied with the disclosure requirements in a Statement of Financial Accounting Standards. Which of the following information sources would the CPA most likely consult for this information?

A. AICPA Accounting Trends & Techniques.
B. FASB Technical Bulletins.
C. AICPA Audit and Accounting Manual.
D. FASB Statements of Financial Accounting Concepts.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The AICPA's Accounting Trends & Techniques is an annual survey of accounting practices followed in 600 stockholders' annual reports.
Choice "b" is incorrect. FASB Technical Bulletins are considered to be a source of established accounting principles that expand upon or further clarify GAAP. They do not provide information regarding how various companies comply with
GAAP.
Choice "c" is incorrect. AICPA Audit and Accounting Guides are interpretive publications that provide additional guidance regarding the application of auditing standards. They do not provide information regarding how various companies comply with GAAP.
Choice "d" is incorrect. FASB Statements of Financial Accounting Concepts establish the objectives and concepts for use by the FASB in developing accounting and reporting standards. They do not provide information regarding how various companies comply with GAAP.

QUESTION 401
An auditor's engagement letter most likely would include a statement regarding:

A. Management's responsibility to provide certain written representations to the auditor.
B. Conditions under which the auditor may modify the preliminary judgment about materiality.
C. Internal control activities that would reduce the auditor's assessment of risk.
D. Materiality matters that could modify the auditor's preliminary assessment of fraud risk.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The auditor is required to establish an understanding with the client, and this understanding should be documented in the form of an engagement letter. The understanding (and therefore the letter) should encompass management's responsibilities, which include providing the auditor with a representation letter at the conclusion of the engagement.
Choices "b", "c", and "d" are incorrect. An understanding generally is not obtained with respect to specific audit procedures, and therefore these items would not be included in an engagement letter.

QUESTION 402
A successor auditor should make specific and reasonable inquiries of the predecessor auditor regarding the predecessor's:

A. Understanding of the reasons for the change in auditors.
B. Methodology used in applying sampling techniques.
C. Opinion on subsequent events that have occurred since the balance sheet date.
D. Perception of the competency and reliance on the client's internal audit function.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The successor auditor is required to make inquiries of the predecessor auditor before accepting an engagement. These inquiries should include the predecessor's understanding as to the reasons for the change in auditors.
Choice "b" is incorrect. The successor auditor would not typically inquire regarding audit methodology used during the prior audit.
Choices "c" and "d" are incorrect. The successor auditor is responsible for making his or her own judgments regarding the audit, and would not typically inquire regarding the predecessor auditor's judgments with respect to subsequent events or the internal audit function.

QUESTION 403
An auditor reviews a client's accounting policies and procedures when considering which of the following planning matters?

A. Method of sampling to be used.

B. Preliminary judgments about materiality levels.
C. Nature of reports to be rendered.
D. Understanding the client's operations and business.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. An auditor would review the client's accounting policies and procedures as part of obtaining an understanding of the client's operations and business. This understanding is important because it affects the design of internal control, which in turn impacts planned auditing procedures.
Choice "a" is incorrect. Although the auditor might consider the client's accounting policies and procedures when designing a sampling plan, this is not the primary reason for the auditor's review of the client's policies and procedures.
Choice "b" is incorrect. The client's accounting policies and procedures would not affect preliminary judgments about materiality, which are generally based on either annualized interim financial statements or annual financial statements from a prior period.
Choice "c" is incorrect. The client's accounting policies and procedures would not affect the nature of reports to be rendered. The nature of reports to be rendered would be based on the type of engagement and the specific results of that engagement.

QUESTION 404
An auditor is required to obtain an understanding of the entity's business, including business cycles and reasons for business fluctuations. What is the audit purpose most directly served by obtaining this understanding?

A. To enable the auditor to accurately identify significant deficiencies in internal control.
B. To assist the auditor in accurately interpreting information obtained during an audit.
C. To allow the auditor to more accurately perform tests of controls.
D. To decide whether it will be necessary to perform analytical procedures.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. As part of audit planning, the auditor should obtain an understanding of the entity's business. This understanding enables the auditor to

better understand events, transactions, and practices that may affect the financial statements, to plan and perform appropriate audit tests, and to properly understand and evaluate the results of those tests.
Choice "a" is incorrect. Obtaining an understanding of the entity's business would not be particularly helpful in identifying significant deficiencies in internal control. Also, such deficiencies are typically identified during the fieldwork stage of the audit, while obtaining an understanding of the entity's business typically occurs during planning.
Choice "c" is incorrect. Obtaining an understanding of the entity's business would not result in a more accurate performance of tests of controls. Accurate performance of audit tests is dependent upon factors such as existence of an appropriate audit trail, client cooperation, training and supervision of audit staff, etc.
Choice "d" is incorrect. Analytical procedures are always required in an audit, during the planning and overall review stages.

QUESTION 405
A retail entity uses electronic data interchange (EDI) in executing and recording most of its purchase transactions. The entity's auditor recognizes that the documentation of the transactions will be retained for only a short period of time. To compensate for this limitation, the auditor most likely would:

A. Increase the sample of EDI transactions to be selected for cutoff tests.
B. Perform tests several times during the year, rather than only at year-end.
C. Plan to make a 100% count of the entity's inventory at or near the year-end.
D. Decrease the assessed level of control risk for the existence or occurrence assertions.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. When an entity transmits, processes, maintains, or accesses significant information electronically, some accounting data and source documents may be available only in electronic form, or only at a certain point in time.
The auditor would generally perform tests of controls several times during the year to compensate for this limitation.
Choice "a" is incorrect. Increasing the sample size related to cutoff testing will not provide evidence about transactions occurring throughout the period under audit, since cutoff testing relates to year-end.
Choice "c" is incorrect. Auditing 100% of the year-end inventory does not provide evidence about transactions occurring throughout the period under audit.
Choice "d" is incorrect. Failure to retain documentation for longer periods of time would not imply that control risk is reduced. If anything, this might lead to an increase in control risk, making it less likely that phony transactions would be detected after the fact.

QUESTION 406
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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the assessed risk of material misstatement, which in turn affects the acceptable level of detection risk for financial statement assertions.
Choice "a" is incorrect. The auditor assesses control risk after obtaining an understanding of internal control. Assessment is not required to obtain an understanding of the control environment or any of the other four components of internal control.
Choice "b" is incorrect. Assessment of control risk is unrelated to assessments of materiality levels.
Choice "c" is incorrect. Inherent risk is assessed independently of any consideration of relevant controls.
Control risk does not affect inherent risk.

QUESTION 407
As the acceptable level of detection risk decreases, an auditor may:

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

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase. Consequently, the auditor should do one or more of the following: 1) change the nature of substantive tests from a less effective to a more effective procedure, 2) change the timing of the substantive tests, such as performing them at year-end rather than at an interim date, or 3) change the extent of substantive tests, such as using a

larger sample size.
Choice "a" is incorrect. As acceptable detection risk decreases, the extent of substantive tests should increase rather than decrease. The auditor cannot reassess inherent risk and control risk to compensate for the lower acceptable detection risk.
Choice "c" is incorrect. Inherent risk is an integral part of the risk of material misstatement and cannot be eliminated from the computation of acceptable detection risk. Choice "d" is incorrect. The auditor cannot lower the assessed level of control risk unless tests of controls support that assessment.

QUESTION 408
Control risk should be assessed in terms of:

A. Specific controls.
B. Types of potential irregularities.
C. Financial statement assertions.
D. Control environment factors.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The auditor identifies internal controls relevant to specific financial statement assertions, and then performs tests of controls to evaluate their effectiveness in preventing material misstatements in those assertions. Control risk should be assessed in terms of financial statement assertions.
Choice "a" is incorrect. Control risk is not assessed in terms of specific controls.
Choice "b" is incorrect. Control risk is not assessed in terms of types of potential fraud.
Choice "d" is incorrect. Control risk is not assessed in terms of control environment factors.

QUESTION 409
The acceptable level of detection risk is inversely related to the:

A. Assurance provided by substantive tests.
B. Risk of misapplying auditing procedures.
C. Preliminary judgment about materiality levels.
D. Risk of failing to discover material misstatements.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The acceptable level of detection risk is inversely related to the assurance provided by substantive tests. For example, if the acceptable level of detection risk decreases, more assurance is required from substantive tests.
Choice "b" is incorrect. The acceptable level of detection risk is determined independently of the risk of misapplying auditing procedures (non-sampling risk).
Choice "c" is incorrect. The acceptable level of detection risk is determined independently of the preliminary judgment about materiality levels (tolerable error).
Choice "d" is incorrect. The acceptable level of detection risk is directly related to the risk of failing to discover material misstatements (audit risk).

QUESTION 410
Samples to test internal control are intended to provide a basis for an auditor to conclude whether:

A. The control activities are operating effectively.
B. The financial statements are materially misstated.
C. The risk of incorrect acceptance is too high.
D. Materiality for planning purposes is at a sufficiently low level.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Samples to test internal control are intended to provide a basis for an auditor to conclude whether the control activities are operating effectively.
Choice "b" is incorrect. Tests of controls may provide evidence regarding the likelihood of misstatement, but they do not provide a basis for concluding whether the financial statements are materially misstated. Choice "c" is incorrect. The risk of incorrect acceptance is an aspect of sampling risk related to substantive tests, not tests of controls. Choice "d" is incorrect. Samples to test controls do not provide evidence regarding materiality levels for planning purposes.

QUESTION 411
Which of the following factors most likely would lead a CPA to conclude that a potential audit engagement should not be accepted?

A. There are significant related party transactions that management claims occurred in the ordinary course of business.
B. Internal control activities requiring the segregation of duties are subject to management override.
C. Management continues to employ an inefficient system of information technology to record financial transactions.

D. It is unlikely that sufficient appropriate audit evidence is available to support an opinion on the financial statements.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. If it is unlikely that sufficient appropriate audit evidence will be available to support an opinion on the financial statements, it would be pointless to conduct an audit.
Choice "a" is incorrect. The existence of significant related party transactions would not prevent the auditor from accepting an audit engagement, regardless of the whether or not such transactions occurred in the ordinary course of business.
The auditor would simply need to evaluate management's methods for identifying and disclosing related party transactions, and ultimately evaluate financial statement disclosure, as part of the audit.
Choice "b" is incorrect. Internal control activities are often subject to management override, but this is no reason to reject a potential audit engagement. Rather, this risk should be assessed, and audit procedures should be designed only after taking into account the assessed level of risk.
Choice "c" is incorrect. An inefficient system of information technology for recording financial transactions may not be optimal for the company, but as long as it is an effective system (i.e., as long as it provides reliable financial reporting), it will not affect the auditor's decision regarding acceptance of a new audit engagement.

QUESTION 412
Prior to commencing field work, an auditor usually discusses the general audit strategy with the client's management. Which of the following details do management and the auditor usually agree upon at this time?

A. The specific matters to be included in the communication with those charged with governance.
B. The minimum amount of misstatements that may be considered to be significant deficiencies in internal control.
C. The schedules and analyses that the client's staff should prepare.
D. The effects that inadequate controls may have over the safeguarding of assets.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Prior to commencing field work, the auditor would likely discuss with management any assistance desired from client staff. This is part of

establishing an understanding with the client. Choice "a" is incorrect. Prior to commencing field work, the auditor likely would be unaware of the specific matters to be included in the communication to those charged with governance.
Choice "b" is incorrect. While the auditor may set a preliminary measure of materiality, this is a matter of auditing judgment and would not typically be discussed with the client. In addition, significant internal control weaknesses are reported because they indicate a potential for material misstatement, regardless of whether any actual misstatements exceed a particular threshold.
Choice "d" is incorrect. Prior to commencing field work, the auditor would be unlikely to have identified inadequate controls or evaluated their possible effects.

QUESTION 413
As the acceptable level of detection risk increases, an auditor may change the:

A. Assessed level of control risk from low to high.
B. Assurance provided by tests of controls by using a larger sample size than planned.
C. Timing of substantive tests from year-end to an interim date.
D. Nature of substantive tests from a less effective to a more effective procedure.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. As the acceptable level of detection risk increases, the assurance (effectiveness) that must be provided from substantive tests can decrease. Thus the auditor may change the timing of substantive tests from year-end to an interim date.
Choice "a" is incorrect. The assessed level of control risk is used to determine the acceptable level of detection risk, not vice versa.
Choice "b" is incorrect. The acceptable level of detection risk affects the nature, timing and extent of substantive audit procedures, not control tests.
Choice "d" is incorrect. As the acceptable level of detection risk increases, the level of assurance required from substantive tests decreases, and therefore the substantive procedures need not be as effective.

QUESTION 414
An auditor plans to apply substantive tests to the details of asset and liability accounts as of an interim date rather than as of the balance sheet date. The auditor should be aware that this practice:

A. Eliminates the use of certain statistical sampling methods that would otherwise be available.
B. Presumes that the auditor will reperform the tests as of the balance sheet date.
C. Should be especially considered when there are rapidly changing economic conditions.
D. Potentially increases the risk that errors that exist at the balance sheet date will not be detected.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Applying substantive tests to the details of asset and liability accounts as of an interim date increases risk, as it is possible that errors will occur between the date of interim testing and the balance sheet date. For this reason, the auditor generally selects for interim examination only accounts that are reasonably predictable with respect to amount, relative significance, and composition, and must also identify procedures sufficient to extend interim conclusions to year-end.
Choice "a" is incorrect. The use of statistical sampling methods is not affected by the timing of audit procedures.
Choice "b" is incorrect. Applying substantive tests to the details of asset and liability accounts as of an interim date increases risk, but it does not require all such tests to be reperformed. Instead, the auditor should perform procedures designed to extend the interim conclusions to year-end. Such procedures should be less in scope than the initial procedures performed at interim; otherwise, it would make more sense to have simply applied the more extensive tests at yearend in the first place.
Choice "c" is incorrect. Generally, accounts selected for interim examination should be reasonably predictable with respect to amount, relative significance, and composition. Rapidly changing economic conditions might affect the valuation, significance, or composition of certain assets or liabilities, and therefore would make testing at interim less likely.

QUESTION 415
Regardless of the assessed level of control risk, an auditor would perform some:

A. Tests of controls to determine the effectiveness of internal control.
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.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Regardless of the assessed level of control risk, an auditor would perform some level of substantive tests to restrict detection risk for significant transaction classes. Even with the lowest possible assessed level of control risk, substantive testing cannot be entirely eliminated for significant transaction classes or balances.

Choice "a" is incorrect. An auditor generally would not perform tests of controls if it would not be efficient to do so.
Choice "b" is incorrect. Analytical procedures are substantive audit procedures used by the auditor to test account balances, not to verify the design of internal controls. Choice "d" is incorrect. Dual purpose tests are often performed because they increase audit efficiency, but they are not required to be performed in every case.

QUESTION 416
In assessing the competence of a client's internal auditor, an independent auditor most likely would consider the:

A. Internal auditor's compliance with professional internal auditing standards.
B. Client's policies that limit the internal auditor's access to management salary data.
C. Evidence supporting a low assessed level of control risk.
D. Results of ratio analysis that may identify unusual transactions and events.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. In assessing the competence of a client's internal auditor, an independent auditor would consider the internal auditor's compliance with professional auditing standards. Such compliance could be evaluated by reviewing the audit plan and auditing procedures used by the internal auditor, as well as by assessing the quality of audit documentation provided.
Choice "b" is incorrect. The internal auditor's access to management salary data has no bearing on his or her competency.
Choice "c" is incorrect. The external auditor's assessment of control risk might be based in part on the existence and effectiveness of an internal audit group, but such assessment would not provide information regarding the competency of the internal auditor.
Choice "d" is incorrect. Ratio analysis might be used to identify unusual transactions or events, but it would not provide information regarding the competency of the internal auditor.

QUESTION 417
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.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. As the assessed level of control risk increases, the acceptable level of detection risk for financial statement assertions decreases. To attain a decreased level of detection risk, greater assurance is needed from substantive tests. Increasing the extent of tests will provide greater assurance.
Choice "a" is incorrect. Tests of controls are used to assess the level of control risk. Once such assessment is made, there is no need to perform further tests of controls.
Choice "b" is incorrect. As the assessed level of control risk increases, the acceptable level of detection risk decreases. In this way, the auditor can keep total audit risk to an acceptable level. Choice "d" is incorrect. Inherent risk is based on the nature of the assertion and cannot be changed.

QUESTION 418
A successor auditor is required to attempt communication with the predecessor auditor prior to:

A. Performing test of controls.
B. Testing beginning balances for the current year.
C. Making a proposal for the audit engagement.
D. Accepting the engagement.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. A successor auditor is required to attempt communication with the predecessor auditor prior to accepting a new engagement.
Choice "a" is incorrect. A successor auditor is required to attempt communication with the predecessor auditor prior to accepting a new engagement. This certainly implies that such attempt will be made before any audit tests are performed; however, the requirement is stated in reference to the date of acceptance.
Choice "b" is incorrect. A successor auditor is required to attempt communication with the predecessor auditor prior to accepting a new engagement. This certainly implies that such attempt will be made before any audit tests are performed; however, the requirement is stated in reference to the date of acceptance.
Choice "c" is incorrect. A successor auditor is not required to attempt communication with the predecessor auditor prior to making a proposal for the audit engagement (remember that more than one auditor may be bidding for the engagement -- and it wouldn't be reasonable to expect the predecessor auditor to respond to all bidders). However, once a successor has been selected, that auditor must attempt communication with the predecessor auditor before actually accepting the engagement.

QUESTION 419
An auditor uses the assessed level of control risk to:

A. Evaluate the effectiveness of the entity's internal control.
B. Identify transactions and account balances where inherent risk is at the maximum.
C. Indicate whether materiality thresholds for planning and evaluation purposes are sufficiently high.
D. Determine the acceptable level of detection risk for financial statement assertions.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. An auditor uses the assessed level of control risk to determine the risk of material misstatement, which in turn determines the acceptable level of detection risk for financial statement assertions. Detection risk should bear an inverse relationship to control risk. For example, the less control risk an auditor believes exists, the greater the level of detection risk he or she can accept.
Choice "a" is incorrect. The auditor's evaluation of the effectiveness of the entity's internal control is what the auditor uses to assess control risk, not vice versa.
Choice "b" is incorrect. Inherent risk, which is the susceptibility of an assertion to a material misstatement based upon the nature of the account balance or transaction class, exists independently from and bears no direct relationship to control risk.
Choice "c" is incorrect. Materiality thresholds for planning and evaluation purposes are based upon measurements of financial criteria, not the assessed level of control risk.

QUESTION 420
If the business environment is experiencing a recession, the auditor most likely would focus increased attention on which of the following accounts?

A. Purchase returns and allowances.
B. Allowance for doubtful accounts.
C. Common stock.
D. Noncontrolling interest of a subsidiary purchased during the year.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:

Section: Volume C

Choice "b" is correct. During an economic downturn, it is more likely that customers will default on payments owed. The auditor should therefore focus increased attention on the allowance for doubtful accounts, to ensure that it has been adjusted to appropriately reflect this increased risk.
Choice "a" is incorrect. A recession is not likely to affect purchase returns and allowances, though it might result in a decline in purchases. Choice "c" is incorrect. A recession is not likely to directly affect the common stock account.
Choice "d" is incorrect. A recession is not likely to directly affect a pre-existing, noncontrolling interest in a subsidiary.

QUESTION 421
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.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The existence of audit risk is recognized by the statement in the auditor's standard report that the auditor obtains "reasonable assurance" (as opposed to absolute assurance) about whether the financial statements are free of material misstatement. The existence of audit risk (the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on materially misstated financial statements) is implied in this statement.
Choice "b" is incorrect. Assessing the accounting principles used and evaluating the overall financial statement presentation relate to determining that the statements have been prepared in conformity with GAAP, not to recognizing the existence of audit risk.
Choice "c" is incorrect. Realizing that some matters are more important than others illustrates the concept of materiality; however, this is not a statement included in the auditor's standard report.
Choice "d" is incorrect. Indicating that the financial statements are the responsibility of management while the auditor's responsibility is to express an opinion on those financial statements delineates responsibility rather than illustrating the concept of audit risk.

QUESTION 422
As the acceptable level of detection risk decreases, the assurance directly provided from:

A. Substantive tests should increase.
B. Substantive tests should decrease.

C. Tests of controls should increase.
D. Tests of controls should decrease.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. As the acceptable level of detection risk (the risk that an auditor will not detect a material misstatement that exists in an assertion) decreases, the assurance directly provided from substantive tests should increase. The level of detection risk will decline as the benefit of direct tests increases. Choice "b" is incorrect. If the assurance directly provided from substantive tests decreased, detection risk would increase because the direct tests have become less beneficial. Choices "c" and "d" are incorrect. Changing the extent of tests of controls does not affect the level of detection risk.

QUESTION 423
On the basis of audit evidence gathered and evaluated, an auditor decides to increase the assessed level of control risk, and therefore the risk of material misstatement, 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:

A. Increase inherent risk.
B. Increase materiality levels.
C. Decrease substantive testing.
D. Decrease detection risk.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Decrease "detection risk." Overall audit risk is made up of the risk of material misstatement and detection risk. The risk of material misstatement is itself comprised of two separate risks, inherent risk and control risk.
When the assessed level of control risk is increased, the risk of material misstatement also increases, and detection risk must be decreased to achieve an overall audit risk level that is substantially the same as the planned audit risk level. Choice "a" is incorrect. The auditor cannot change inherent risk.
Choice "b" is incorrect. The established materiality level is not a component of overall audit risk.

Choice "c" is incorrect. If the assurance directly provided from substantive tests decreased, detection risk would increase because direct tests have become less beneficial.

QUESTION 424
Which of the following would an auditor most likely use in determining the auditor's preliminary judgment about materiality?

A. The results of the initial assessment of control risk.
B. The anticipated sample size for planned substantive tests.
C. The entity's financial statements of the prior year.
D. The assertions that are embodied in the financial statements.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The auditor would most likely use the entity's financial statements of the prior year in the preliminary determination of materiality. The prior year financial statements would be a good starting point in estimating the current year's expected results, especially for a continuing client.
Choice "a" is incorrect. The assessment of control risk affects the design of audit procedures but is not relevant in determining materiality.
Choice "b" is incorrect. The anticipated sample size for planned substantive tests is set after the preliminary materiality level is determined. Choice "d" is incorrect. Management assertions embodied in the financial statements have little relationship to materiality.

QUESTION 425
Holding other planning considerations equal, a decrease in the amount of misstatements in a class of transactions that an auditor could tolerate most likely would cause the auditor to:

A. Apply the planned substantive tests prior to the balance sheet date.
B. Perform the planned auditing procedures closer to the balance sheet date.
C. Increase the assessed level of control risk for relevant financial statement assertions.
D. Decrease the extent of auditing procedures to be applied to the class of transactions.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:

Section: Volume C

Choice "b" is correct. A decrease in the amount of misstatements that the auditor can tolerate will cause the auditor to modify the nature, timing and/or extent of auditing procedures. Performing the planned procedures closer to the balance sheet date is a timing modification that addresses this change.
Choice "a" is incorrect. The auditor would perform substantive procedures before year-end if the amount of misstatements the auditor could tolerate were increased. The earlier in the year that the auditor performs substantive testing, the greater the incremental risk the auditor accepts regarding the year-end financial statements.
Choice "c" is incorrect. A change in the level of tolerable misstatement does not have a direct effect on the assessed level of control risk.
Choice "d" is incorrect. A decrease in the amount of misstatements that can be tolerated would necessitate an increase in the extent of auditing procedures.

QUESTION 426
When issuing an unqualified opinion, the auditor who evaluates the audit findings should be satisfied that the:

A. Amount of known misstatement is documented in the management representation letter.
B. Estimate of the total misstatement is less than a material amount.
C. Amount of known misstatement is acknowledged and recorded by the client.
D. Estimate of the total likely misstatement includes the adjusting entries already recorded by the client.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. An unqualified opinion states that the financial statements are presented fairly, in all material respects. Accordingly, if the auditor believes that total misstatement (including both known and likely misstatements) is immaterial, an unqualified opinion is appropriate.
Choice "a" is incorrect. Documenting misstatements in the management representation letter is not required, nor would it eliminate the need to modify the opinion if the known misstatements were material.
Choice "c" is incorrect. Even if the client adjusts the financial statements to correct known misstatements, the auditor still must feel comfortable that any remaining unidentified misstatements would not be material to the financial statements before rendering an unqualified opinion.
Choice "d" is incorrect. An auditor is not concerned with misstatements already corrected by the client. It is the auditor's estimate of uncorrected--and perhaps unknown--errors that affects the type of opinion rendered.

QUESTION 427
Which of the following procedures would an auditor most likely include in the planning phase of a financial statement audit?

A. Obtain an understanding of the entity's risk assessment process.

B. Identify specific internal control activities designed to prevent fraud.
C. Evaluate the reasonableness of the entity's accounting estimates.
D. Perform cutoff tests of the entity's sales and purchases.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. In all audits, the auditor should obtain a sufficient understanding of each of the five components of internal control in order to properly plan the audit. The entity's risk assessment process is one of the five components of internal control.
Choice "b" is incorrect. Identification and testing of specific control activities generally occurs during the performance of the audit.
Choice "c" is incorrect. Evaluating the reasonableness of accounting estimates generally occurs during the performance of the audit. Choice "d" is incorrect. Cutoff testing of sales and purchases generally occurs during the performance of the audit.

QUESTION 428
In designing a written audit plan, 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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. In designing a written audit plan, an auditor should establish specific audit objectives that relate primarily to the financial statement assertions.
Choice "a" is incorrect. Although the timing of audit procedures is an important consideration in designing a written audit plan, obtaining audit evidence relating to the financial statement assertions is the primary objective.
Choice "b" is incorrect. The cost-benefit of gathering evidence is an important consideration in establishing a written audit plan, but audit objectives are not

based on such considerations.
Choice "c" is incorrect. The specific audit objectives should relate primarily to financial statement assertions. Selected audit techniques are then developed in order to meet the identified objectives.

QUESTION 429
Which of the following is not a type of financial statement assertion?

A. Rights and obligations.
B. Fairness and accuracy.
C. Valuation and allocation.
D. Understandability and classification.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. "Fairness and accuracy" is not a type of financial statement assertion. Choices "a", "c", and "d" are incorrect. The assertions include:
Rights and obligations
Valuation and allocation
Understandability and classification

QUESTION 430
Which of the following factors most likely would influence an auditor's determination of the auditability of an entity's financial statements?

A. The complexity of the accounting system.
B. The existence of related party transactions.
C. The adequacy of the accounting records.
D. The operating effectiveness of control activities.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. An auditor cannot audit inadequate accounting records (i.e., records that do not exist or are so poor that they cannot be relied upon).
Choices "a" and "b" are incorrect. The following factors would be considered when accepting an audit engagement and might require extensions of audit work, but are not factors that would prevent the financial statements from being audited:
A. The complexity of the accounting system.
B. The existence of related party transactions.
Choice "d" is incorrect. The operating effectiveness of control activities does not affect the auditability of financial statements, and it is not considered when accepting an audit engagement.

QUESTION 431
Which of the following auditor concerns most likely could be so serious that the auditor concludes that a financial statement audit cannot be conducted?

A. The entity has no formal written code of conduct.
B. The integrity of the entity's management is suspect.
C. Procedures requiring segregation of duties are subject to management override.
D. Management fails to modify prescribed controls for changes in conditions.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. An auditor's faith in the integrity of management is of the utmost importance in performing a financial statement audit. When an auditor is concerned that the integrity of management is suspect, the situation is serious enough to prevent the auditor from performing the audit.
Choice "a" is incorrect. A lack of a written code of conduct is not unusual in a small company and certainly would not prevent an audit from being performed.
Choice "c" is incorrect. Procedures requiring segregation of duties are almost always subject to management override, even in the best internal control system.
Choice "d" is incorrect. An auditor would simply modify the appropriate audit procedures when management fails to modify prescribed controls for changes in conditions.

QUESTION 432
In developing an overall audit strategy, an auditor should consider:

A. Whether the allowance for sampling risk exceeds the achieved upper precision limit.
B. Findings from substantive tests performed at interim dates.
C. Whether the inquiry of the client's attorney identifies any litigation, claims, or assessments not disclosed in the financial statements.

D. Preliminary evaluations of materiality, audit risk, and internal control.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. In developing an overall audit strategy, an auditor should consider preliminary evaluations of materiality, audit risk, and internal control.
Choice "a" is incorrect. Evaluation of results from sampling applications would be performed during fieldwork, after the planning process has been completed.
Choice "b" is incorrect. Findings from interim audit testing would be considered during fieldwork, after the planning process has been completed.
Choice "c" is incorrect. Inquiry of a client's attorney and evaluation of the attorney's response is performed during fieldwork, after the planning process has been completed.

QUESTION 433
A retailing entity uses the Internet to execute and record its purchase transactions. The entity's auditor recognizes that the documentation of details of transactions will be retained for only a short period of time. To compensate for this limitation, the auditor most likely would:

A. Compare a sample of paid vendors' invoices to the receiving records at year-end.
B. Plan for a large measure of tolerable misstatement in substantive tests.
C. Perform tests several times during the year, rather than only at year-end.
D. Increase the sample of transactions to be selected for cutoff tests.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. When an entity transmits, processes, maintains, or accesses significant information electronically, some accounting data and source documents may be available only in electronic form, or only at a certain point in time.
The auditor would generally perform tests of controls several times during the year to compensate for this limitation.
Choice "a" is incorrect. Comparing a sample of paid vendors' invoices to receiving records provides evidence that the company received the goods for which it paid, but only if records are available in sufficient detail to make such a comparison. If detailed records are retained for only a short period of time, such comparisons would need to be performed throughout the year, not just at year-end.
Choice "b" is incorrect. The auditor's judgment as to an appropriate level of tolerable misstatement is based on considerations of materiality and audit risk.

Increasing this level implies that the auditor is willing to accept a larger error, which would not be an appropriate response to the limitation described.
Choice "d" is incorrect. Increasing the sample size related to cutoff testing will not provide evidence about transactions occurring throughout the period under audit, since cutoff testing relates to year-end.

QUESTION 434
Prior to commencing fieldwork, an auditor usually discusses the general audit strategy with the client's management. Which of the following matters do the auditor and management agree upon at this time?

A. The appropriateness of the entity's plans for dealing with adverse economic conditions.
B. The determination of the fraud risk factors that exist within the client's operations.
C. The control weaknesses to be included in the communication with those charged with governance.
D. The coordination of the assistance of the client's personnel in data preparation.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Prior to commencing fieldwork, an auditor would establish an understanding with the client as to the services to be performed and the overall audit strategy. This understanding may include arrangements involving the conduct of the engagement, such as timing, client assistance, and the availability of documents.
Choice "a" is incorrect. The auditor does not evaluate the appropriateness of the entity's plans for dealing with adverse economic conditions prior to commencing fieldwork. The auditor might consider this as part of evaluating the client's ability to continue as a going concern, but this would not occur prior to commencing fieldwork.
Choice "b" is incorrect. Determination of existing fraud risk factors is generally made during the fieldwork stage of the audit, as information and evidence is obtained. Also, fraud risk factors are assessed by the auditor, and would not necessarily be agreed upon with management.
Choice "c" is incorrect. Identification and evaluation of control weaknesses generally occurs during the fieldwork stage of the audit, as information and evidence is obtained, not prior to the commencement of fieldwork.

QUESTION 435
An auditor's engagement letter most likely would include a statement that:

A. Lists potential significant deficiencies discovered during the prior year's audit.
B. Explains the analytical procedures that the auditor expects to apply.
C. Describes the auditor's responsibility to evaluate going concern issues.
D. Limits the auditor's responsibility to detect errors and fraud.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. An auditor's engagement letter typically includes discussion of limitations of the engagement, such as the fact that the auditor will obtain only reasonable assurance, and therefore a material misstatement may remain undetected.
Choice "a" is incorrect. An auditor's engagement letter typically covers the objectives of the engagement, management's responsibilities, the auditor's responsibilities, limitations of the engagement, and other matters involving the conduct of the audit. Potential significant deficiencies discovered during the prior year's audit would not typically be included in the engagement letter.
Choice "b" is incorrect. While the auditor's engagement letter might include a discussion of the overall audit strategy, it typically would not include specific audit procedures.
Choice "c" is incorrect. While the auditor's engagement letter might include a discussion of the auditor's responsibilities, this is usually discussed in fairly general terms. An engagement letter would not describe the auditor's responsibility with respect to specific issues (such as going concern issues).

QUESTION 436
Which of the following statements is correct concerning materiality in a financial statement audit?

A. Analytical procedures performed during an audit's review stage usually decrease materiality levels.
B. If the materiality amount used in evaluating audit findings increases from the amount used in planning, the auditor should apply additional substantive tests.
C. The auditor's materiality judgments generally involve quantitative, but not qualitative, considerations.
D. Materiality levels are generally considered in terms of the smallest aggregate level of misstatement that could be considered material to any one of the financial statements.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Because the financial statements are interrelated, materiality levels are generally considered in terms of the smallest level of misstatement that could be material to any one of the financial statements.
Choice "a" is incorrect. Analytical procedures are performed during an audit's review stage to evaluate the overall financial statement presentation and to assess the conclusions reacheD. They generally would not result in a change in materiality levels.

Choice "b" is incorrect. If the materiality amount used in evaluating audit findings increases from the amount used in planning, the auditor should consider whether the audit plan needs to be modified.
Typically, an increase in materiality levels would result in a decrease in audit risk, which would result in less substantive testing, not more.
Choice "c" is incorrect. Qualitative considerations may lead to situations in which misstatements that do not exceed materiality limits are still likely to influence the economic decisions of users. In such cases, an otherwise immaterial misstatement is deemed to be material.

QUESTION 437
Which of the following is an analytical procedure that an auditor most likely would perform when planning an audit?

A. Confirming bank balances with the financial institutions.
B. Scanning accounts receivable for amounts over credit limits.
C. Recalculating inventory extensions of physical inventory counts.
D. Comparing the current-year account balances for conformity with predictable patterns.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. During planning, analytical procedures consist of a review of data aggregated at a high level, with an objective of enhancing the auditor's understanding of the client. Comparing the current-year account balances for conformity with predictable patterns would fulfill this purpose.
Choice "a" is incorrect. Confirmation of bank balances is a substantive audit procedure (not an analytical procedure) that would be performed during the fieldwork stage of the audit.
Choice "b" is incorrect. Scanning accounts receivable for amounts over credit limits is a detailed procedure related to one specific account, and it would be performed during the fieldwork stage of the audit.
Choice "c" is incorrect. Recalculating inventory extensions of physical inventory counts is a detailed procedure related to one specific account, and it would be performed during the fieldwork stage of the audit.

QUESTION 438
An auditor intends to use the work of an actuary who has a relationship with the client. Under these circumstances, the auditor:

A. Is required to disclose the contractual relationship in the auditor's report.
B. Should assess the risk that the actuary's objectivity might be impaired.
C. Is not permitted to rely on the actuary because of a lack of independence.
D. Should communicate this matter to those charged with governance as a significant deficiency in internal control.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. While a specialist who is unrelated to the client will provide the auditor with greater assurance of reliability, a specialist who is related to the client may be acceptable in certain circumstances. In such situations, the auditor would likely perform additional procedures to verify objectivity.
Choice "a" is incorrect. If the auditor is expressing a standard unqualified opinion, no reference would be made to the specialist in the auditor's report.
Choice "c" is incorrect. While a specialist who is unrelated to the client will provide the auditor with greater assurance of reliability, a specialist who is related to the client may be acceptable in certain circumstances. Choice "d" is incorrect. The fact that the actuary has a relationship with the client is not considered to be a significant deficiency in internal control.

QUESTION 439
Before applying principal substantive tests to an entity's accounts receivable at an interim date, an auditor should:

A. Consider the likelihood of assessing the risk of incorrect rejection too low.
B. Project sampling risk at the maximum for tests covering the remaining period.
C. Ascertain that accounts receivable are immaterial to the financial statements.
D. Assess the difficulty in controlling the incremental audit risk.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. When audit procedures are performed before year-end, the auditor must assess the incremental risk involved and determine whether sufficient alternative procedures exist to extend the interim conclusions to year-end. Choice "a" is incorrect. The risk of incorrect rejection relates to the efficiency of audit testing, since an item that is initially (and erroneously) rejected will be subject to additional audit testing that should correct the error. The likelihood of assessing this risk lower than it should be does not affect the auditor's decision regarding the appropriate timing of audit work.
Choice "b" is incorrect. When audit procedures are performed before year-end, the auditor must assess the incremental risk involved, but this risk would not necessarily be assessed at the maximum level.
Choice "c" is incorrect. Interim testing may be performed on material accounts, as long as the auditor assesses the incremental risk involved and determines whether sufficient alternative procedures exist to extend the interim conclusions to year-end. Immaterial accounts would not need to be tested.

QUESTION 440
Which of the following procedures would a CPA most likely perform in the planning stage of a financial statement audit?

A. Obtain representations from management regarding the availability of all financial records.
B. Communicate with those charged with governance concerning the prior year's audit adjustments.
C. Make inquiries of the client's attorney regarding pending and threatened litigation and assessments.
D. Compare recorded financial information with anticipated results from budgets and forecasts.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The planning process should include application of analytical procedures, such as comparison of the financial statements with budgeted or anticipated results. Choice "a" is incorrect. Management representations are typically obtained at the end of the audit, not during the planning stage.
Choice "b" is incorrect. Assuming all of those charged with governance are not also involved with managing the entity, the auditor is required to communicate with those charged with governance concerning adjustments arising from the current year's audit, not adjustments from the previous year.
Choice "c" is incorrect. Inquiries are typically made of the client's attorney during the fieldwork stage of the audit, not during the planning stage.

QUESTION 441
An auditor is required to establish an understanding with a client regarding the services to be performed for each engagement. This understanding generally includes:

A. The auditor's responsibility for determining the preliminary judgments about materiality and audit risk factors.
B. Management's responsibility for identifying mitigating factors when the auditor has doubt about the entity's ability to continue as a going concern.
C. The auditor's responsibility for ensuring that those charged with governance are aware of any significant deficiencies in internal control that come to the auditor's attention.
D. Management's responsibility for providing the auditor with an assessment of the risk of material misstatement due to fraud.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. An understanding between the auditor and the client generally includes the auditor's responsibilities. One of the auditor's responsibilities is to ensure that those charged with governance (e.g., the audit committee) are aware of any significant deficiencies in internal control that come to the auditor's attention.
Choice "a" is incorrect. An understanding between the auditor and the client generally would not include the auditor's responsibility for determining preliminary judgments about materiality and audit risk factors, as an understanding generally is not obtained with respect to audit procedures or specific audit assessments.
Choice "b" is incorrect. Management is not responsible for identifying mitigating factors when the auditor has doubt about the entity's ability to continue as a going concern. The auditor, however, would look for and evaluate mitigating factors to determine if such factors alleviate doubt about the entity's ability to continue as a going concern.
Choice "d" is incorrect. Management is not responsible for providing the auditor with an assessment of the risk of material misstatement due to fraud. The auditor, however, is responsible for making such an assessment.

QUESTION 442
Which statement is true with respect to discussion among engagement personnel regarding the risk of material misstatement due to fraud?

A. Discussion among engagement personnel regarding the risk of material misstatement due to fraud is recommended but not required.
B. All key members of the audit team should be brought to a single location to facilitate communication.
C. The discussion should occur only during the planning stage of the audit.
D. Audit documentation must include a description of the discussion.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Audit documentation is required to include a description of the discussion among engagement personnel regarding the risk of material misstatement due to fraud.
Choice "a" is incorrect. Discussion among engagement personnel regarding the risk of material misstatement due to fraud is required.
Choice "b" is incorrect. The discussion should include all key members of the audit team, but if an audit involves more than one location, there could be multiple discussions with team members in different locations. Choice "c" is incorrect. Communication among audit team members about the risks of material misstatement due to fraud should continue throughout the audit.

QUESTION 443
Which statement is true regarding the three fraud risk factors (incentives/pressures, opportunity, and rationalization/attitude)?

A. The auditor should determine whether and to what extent fraud risk factors are present as part of the final overall review stage of the audit.
B. The fraud risk factors should be discussed by engagement personnel during planning.

C. The existence of all three fraud risk factors indicates that fraud has occurred.
D. Lack of observation of all three fraud risk factors indicates that fraud has not occurred.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. During planning, the audit team is required to discuss the potential for material misstatement due to fraud, and the fraud risk factors should be included in that discussion.
Choice "a" is incorrect. The auditor should determine whether and to what extent fraud risk factors are present during the planning stage of the audit, not during the final overall review stage.
Choice "c" is incorrect. The existence of all three fraud risk factors does not necessarily imply that fraud has occurred, although it is indicative of a greater risk of fraud.
Choice "d" is incorrect. Lack of observation of all three fraud risk factors does not necessarily imply that fraud has not occurred, as one factor may be significant enough on its own to result in fraud.

QUESTION 444
Which of the following is not an inquiry the auditor should make to identify the risks of material misstatement due to fraud?

A. How management communicates to employees its views on acceptable business practices.
B. Whether operating personnel have communicated to management regarding internal control and how it functions to prevent, deter, or detect material misstatement due to fraud.
C. Whether there are any particular business segments for which a risk of fraud may be more likely to exist.
D. Whether management is aware of any allegations of fraud.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The auditor should inquire whether management (not operating personnel) has communicated to those charged with governance (not management) regarding internal control and how it functions to prevent, deter, or detect material misstatement due to fraud.

Choice "a" is incorrect. The auditor should inquire how management communicates to employees its views on acceptable business practices.
Choice "c" is incorrect. The auditor should inquire whether there are any particular business segments for which a risk of fraud may be more likely to exist.
Choice "d" is incorrect. The auditor should inquire whether management is aware of any allegations of fraud.

QUESTION 445
Which of the following journal entries would the auditor least likely examine in an effort to address the risk of management override of controls?

A. A journal entry made to record recurring periodic accounting estimates.
B. A journal entry made by an individual who does not typically make journal entries.
C. A journal entry recorded as a post-closing entry that has no explanation or description.
D. A journal entry made to a seldom-used account.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Inappropriate or unauthorized journal entries are often used to override controls and manipulate the financial reporting process. Periodic, recurring accounting estimates are least likely to be subject to management override since they are expected and occur regularly.
Choice "b" is incorrect. Inappropriate or unauthorized journal entries are often used to override controls and manipulate the financial reporting process. A journal entry made by a person who generally does not have that responsibility might be indicative of such management override.
Choice "c" is incorrect. Inappropriate or unauthorized journal entries are often used to override controls and manipulate the financial reporting process. A journal entry recorded after closing without an appropriate explanation or description might be indicative of such management override.
Choice "d" is incorrect. Inappropriate or unauthorized journal entries are often used to override controls and manipulate the financial reporting process. A journal entry made to a seldom-used account might be indicative of such management override.

QUESTION 446
Which of the following is least likely to aid the auditor in evaluating the risk of improper revenue recognition due to fraud?

A. Analysis of sales commissions over the most recent five-year period.
B. Comparison of sales volume, as determined from recorded revenue amounts, with production capacity.
C. Trend analysis of revenues and sales returns by month.
D. Comparison of revenue reported by month and by product line for the current and prior years.

Correct Answer: A
Section: Volume C

Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Items other than revenue may affect sales commissions (e.g., changes to the commission structure), and therefore analyzing sales commissions is least likely to aid the auditor in evaluating the risk of improper revenue recognition due to fraud.
Choice "b" is incorrect. An excess of sales volume over production capacity may be indicative of the recording of fictitious sales.
Choice "c" is incorrect. Analysis of sales and returns by month might indicate situations where unauthorized shipments are sent in an effort to overstate revenue. (Larger than average sales in one month would be followed by larger than average returns in the next month.)
Choice "d" is incorrect. Analytical procedures using disaggregated revenue data may indicate unusual relationships that are indicative of fraud.

QUESTION 447
An auditor has identified a risk of material misstatement due to fraud related to the inventory function. Which is least likely to be an appropriate response?

A. Observing inventory counts on an unannounced basis.
B. Requesting that management more closely monitor the inventory function.
C. Assigning more experienced personnel to the engagement.
D. Requesting that inventory be counted on a date close to the end of the reporting period.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. An auditor should respond to fraud risk by designing appropriate audit procedures. Requesting that management more closely monitor the inventory function does not improve the auditor's likelihood of detecting fraud.
Choice "a" is incorrect. Observing inventory counts on an unannounced basis improves the likelihood that the auditor will detect fraud, since perpetrators may be caught unaware and may be less able to hide their fraudulent activities.
Choice "c" is incorrect. Assigning more experienced personnel to the engagement is an appropriate response to identified risk, since more experienced personnel may be less likely to overlook a condition indicative of fraud.
Choice "d" is incorrect. Requesting that inventory be counted on a date close to the end of the reporting period is an appropriate response to identified risk, since it minimizes the risk of manipulation of balances prior to the end of the reporting period.

QUESTION 448
Which of the following factors most likely would 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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The auditor identifies factors indicative of potential fraud ("fraud risk factors") as part of assessing the risk of material misstatement. An overly complex organization structure involving unusual lines of authority provides an opportunity for fraudulent financial reporting that would heighten the auditor's concern.
Choice "a" is incorrect. Large amounts of liquid assets that are easily convertible into cash would heighten an auditor's concern about misappropriation of assets, not about fraudulent financial reporting.
Choice "b" is incorrect. Low growth and profitability might heighten an auditor's concern if it became severe or if management faced excessive pressure to meet financial expectations, but would not necessarily in and of itself heighten an auditor's concern.
Choice "c" is incorrect. Nonfinancial management's participation in the selection of accounting principles might heighten the auditor's concern; financial management is expected to participate in such activities.

QUESTION 449
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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. During every stage of the audit, the auditor should consider the assessment of the risk of material misstatement. During the overall review stage, the auditor should consider whether the results of any of the audit procedures affect the assessment of the risk of material misstatement due to fraud.
Choice "a" is incorrect. The entity's attorney does not provide assurance regarding financial statement disclosure.
Choice "b" is incorrect. Verifying clerical accuracy of client schedules would be performed during the audit, not during the overall review stage. Choice "c" is incorrect. Evaluating whether control weaknesses have been corrected is not typically performed during the overall review stage.

QUESTION 450
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. Those charged with governance are active in overseeing the entity's financial reporting policies.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. When management is dominated by one individual who is also a shareholder, there may be an opportunity for management to override control procedures.
Choice "a" is incorrect. Influence of external parties serves an oversight role that strengthens the control environment and minimizes the effect of management's attitude.
Choice "c" is incorrect. Existence of internal auditors with direct access to the board of directors strengthens the control environment and lessens the effect of management's attitude.
Choice "d" is incorrect. Active participation of those charged with governance serves an oversight role that strengthens the control environment and lessens the effect of management's attitude.

QUESTION 451
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.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. In assessing the risk related to material misstatements in an entity's financial statements, the auditor would consider situations that threaten financial stability or profitability, since such situations might provide an incentive to fraudulently misstate the financial statements. Included as one of these characteristics is declining customer demand.
Choice "b" is incorrect. Even though the bonding of employees who handle cash is recommended, it is not a significant characteristic in assessing the risk related to material misstatement in an entity's financial statements.
Choice "c" is incorrect. Bank reconciliations with in-transit deposits are not unusual and would not heighten the auditor's concern about the risk of material misstatement. In-transit deposits can be verified with the bank at a later date. Choice "d" is incorrect. Since depreciation does not adjust an asset to market value, the sale of equipment at a loss before being fully depreciated is not unusual and would not heighten an auditor's concern.

QUESTION 452
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.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Excessive pressure on management to meet financial targets is a fraud risk factor that would heighten an auditor's concern about the risk of intentional manipulation of financial statements.
Choice "a" is incorrect. Low turnover would reduce the auditor's concern about intentional manipulation of the financial statements.

Choice "b" is incorrect. Insider purchases of company stock would not be a factor that would cause any particular concerns about intentional manipulation of financial statements. Choice "d" is incorrect. A slow rate of change in the entity's industry would reduce the auditor's concern about the risk of intentional manipulation of the financial statements.

QUESTION 453
Which of the following statements reflects an auditor's responsibility for detecting errors and fraud?

A. An auditor is responsible for detecting employee errors and fraud, but not for discovering fraud involving employee collusion or management override.
B. An auditor should plan the audit to detect errors and fraud that are caused by departures from GAAP.
C. An auditor is not responsible for detecting 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 errors and fraud that are material to the financial statements.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The auditor should assess the risk that errors and fraud may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting material errors and fraud.
Choice "a" is incorrect. An auditor is responsible for designing the audit to provide reasonable assurance of detecting material misstatement. This responsibility is the same regardless of the cause of the misstatement. The presence of employee collusion or management override does not change the auditor's responsibility, although it might explain why a properly planned and executed audit did not result in the discovery of material fraud.
Choice "b" is incorrect. The audit should be designed to detect material errors and fraud, regardless of the cause.
Choice "c" is incorrect. The auditor is not "responsible for detecting errors and fraud," but is responsible for designing the audit to provide reasonable assurance of detecting material misstatement, whether due to errors or fraud. Note that the auditor's responsibility relates to the design and execution of the audit, and that even an audit performed in accordance with GAAS may miss a material misstatement.

QUESTION 454
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.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The auditor should consider the implications of an illegal act in relation to other aspects of the audit, particularly the reliability of representations of management. Choice "a" is incorrect. The integrity of the client's attorney would not necessarily be affected by illegal acts performed by the client.
Choice "b" is incorrect. The prior year audit plan would not be affected by the discovery of illegal acts in past years.
Choice "d" is incorrect. The auditor should consider the quantitative and qualitative materiality of the illegal act. However, this does not change the preliminary judgment about materiality levels.

QUESTION 455
Which of the following circumstances most likely would cause an auditor to consider whether material misstatements exist in an entity's financial statements?

A. Management places little emphasis on meeting earnings projections.
B. The board of directors makes all major financing decisions.
C. Significant deficiencies in internal control previously communicated to management are not corrected.
D. Transactions selected for testing are not supported by proper documentation.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Vouching recorded transactions to supporting documentation provides support for the occurrence assertion. The lack of supporting documentation calls into question-the occurrence of the transactions under examination.
Choice "a" is incorrect. Little emphasis on meeting earnings projections would be considered a positive factor in preventing material misstatements from occurring.
Choice "b" is incorrect. As the representatives of shareholder interests, an active board of directors is considered a positive control.
Choice "c" is incorrect. The existence of significant deficiencies in internal control may represent a conscious decision by management to accept that degree of risk because of cost or other considerations. Therefore, although failure to correct such deficiencies is considered a fraud risk factor, the auditor is more likely to

be concerned about transactions that are not supported by proper documentation.

QUESTION 456
Jones, CPA, is auditing the financial statements of XYZ Retailing, Inc. What assurance does Jones provide that direct effect illegal acts that are material to XYZ's financial statements, and illegal acts that have a material, but indirect effect on the financial statements will be detected?

	Direct effect illegal acts	Indirect effect illegal acts
A.	Reasonable	None
B.	Reasonable	Reasonable
C.	Limited	None
D.	Limited	Reasonable

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The auditor should design the audit to provide reasonable assurance that direct effect illegal acts are detected. Because of the nature of illegalities having an indirect effect on the financial statements, the auditor provides no assurance that such acts will be detected.
Choices "b", "c", and "d" are incorrect, based on the above explanation.

QUESTION 457
An auditor concludes that a client has committed an illegal act that has not been properly accounted for or disclosed. The auditor should withdraw from the engagement if the:

A. Auditor is precluded from obtaining sufficient appropriate evidence about the illegal act.
B. Illegal act has an effect on the financial statements that is both material and direct.

C. Auditor cannot reasonably estimate the effect of the illegal act on the financial statements.
D. Client refuses to accept the auditor's report as modified for the illegal act.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The auditor should withdraw from the engagement if the client refuses to accept the auditor's modified report.
Choice "a" is incorrect. If the auditor is precluded from obtaining sufficient evidence, the auditor should consider disclaiming an opinion.
Choice "b" is incorrect. The auditor must consider the effects of a direct material illegality on the financial statements and on other aspects of the audit, but need not withdraw from the engagement. Choice "c" is incorrect. If the auditor cannot estimate the effect of the illegal act on the financial statements, the auditor should consider disclaiming an opinion.

QUESTION 458
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 a high level.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The auditor may conclude that withdrawal is necessary if the client does not take the remedial action that the auditor considers necessary in the circumstances, even when the illegal act is not material to the financial statements.
Choice "a" is incorrect. Whether or not the illegal act is a violation of GAAP does not determine the need to withdraw from the engagement.
Choice "c" is incorrect. An illegal act committed in the prior year would not necessarily cause an auditor to withdraw from a current engagement.
Choice "d" is incorrect. Assessment of control risk at a high level would cause an auditor to modify the nature, timing, or extent of audit procedures, but would

not cause withdrawal from an engagement.

QUESTION 459
Which of the following factors most likely would heighten an auditor's concern about the risk of fraudulent financial reporting?

A. Inability to generate cash flows from operations while reporting substantial earnings growth.
B. Management's lack of interest in increasing the entity's stock trend.
C. Large amounts of liquid assets that are easily convertible into cash.
D. Inability to borrow necessary capital without granting debt covenants.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. An auditor's concern about the risk of fraudulent financial reporting would be heightened if the entity were unable to generate cash flows from operations, but still reported substantial earnings growth, since these two occurrences are somewhat inconsistent.
Choice "b" is incorrect. Management's excessive interest in increasing the stock price and earnings trend is a fraud risk factor; lack of such interest would not cause concern.
Choice "c" is incorrect. Large amounts of liquid assets that are easily convertible into cash would heighten an auditor's concern about misappropriation of assets, not about fraudulent financial reporting. Choice "d" is incorrect. The need to grant debt covenants when borrowing capital is an ordinary occurrence that would not heighten the auditor's concern.

QUESTION 460
Which of the following statements is correct concerning an auditor's responsibility to report fraud?

A. The auditor is required to communicate to those charged with governance all minor fraudulent acts perpetrated by low-level employees, even if the amounts involved are inconsequential.
B. The disclosure of material management fraud to principal stockholders is required when both senior management and the board of directors fail to acknowledge the fraudulent activities.
C. Fraudulent activities involving senior management of which the auditor becomes aware should be reported directly to the SEC.
D. The disclosure of fraudulent activities to parties other than the client's senior management and those charged with governance is not ordinarily part of the auditor's responsibility.

Correct Answer: D
Section: Volume C

Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The disclosure of fraudulent activities to parties other than the client's senior management and those charged with governance is not ordinarily part of the auditor's responsibility.
Choice "a" is incorrect. Only fraud that causes a material misstatement of the financial statements or fraud involving senior management should be reported to those charged with governance.
Choice "b" is incorrect. The disclosure of fraudulent activities to parties other than the client's senior management and those charged with governance is not ordinarily part of the auditor's responsibility.
Although there are certain exceptions to this rule, disclosure to stockholders is not one of them.
Choice "c" is incorrect. Fraudulent activities involving senior management of which the auditor becomes aware should be reported directly to those charged with governance, not to the SEC. (Only in certain limited circumstances would fraud be disclosed to the SEC via required regulatory reports.)

QUESTION 461
Which of the following procedures would least likely result in the discovery of possible illegal acts?

A. Reading the minutes of the board of directors' meetings.
B. Making inquiries of the client's management.
C. Performing tests of details of transactions.
D. Reviewing an internal control questionnaire.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Reviewing an internal control questionnaire provides information about control policies and procedures, but does not provide information about actual transactions or events that have occurred. Therefore, it is not likely to uncover any illegal acts.
Choices "a" and "b" are incorrect. The auditor generally does not include procedures specifically to detect illegal acts, but may discover such acts through other procedures, such as reading the board minutes or making inquiries of management or of legal counsel.
Choice "c" is incorrect. Performing tests of details of transactions may provide information indicative of illegal acts, such as information regarding unauthorized or improperly recorded transactions; payments of unusual fines or penalties; payments that are unusually large or excessive, especially those made in cash; unexplained payments; or payments for unspecified services.

QUESTION 462
Which of the following circumstances most likely would cause an auditor to suspect that there are material misstatements in an entity's financial statements?

A. Senior financial management participates in the selection of accounting principles and the determination of significant estimates.
B. Supporting accounting records and files that should be readily available are not produced promptly when requested.
C. Related party transactions take place in the ordinary course of business with an entity that is audited by another CPA firm.
D. Senior management has an excessive interest in upgrading the entity's information technology capabilities.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Missing or unavailable documents or electronic evidence may be indicative of an intentional material misstatement in the entity's financial statements (fraud).
Choice "a" is incorrect. Senior financial management should participate in the selection of accounting principles and the determination of significant estimates. This would not be indicative of material misstatements in the entity's financial statements.
Choice "c" is incorrect. The auditor would need to audit related party transactions to ensure that there is proper financial statement disclosure, but the existence of such transactions would not be indicative of material misstatements in the entity's financial statements.
Choice "d" is incorrect. The fact that senior management wants to upgrade the entity's information technology capabilities would not be indicative of material misstatements in the entity's financial statements.

QUESTION 463
Which of the following circumstances would an auditor most likely consider a risk factor relating to misstatements arising from fraudulent financial reporting?

A. Several members of management have recently purchased additional shares of the entity's stock.
B. Several members of the board of directors have recently sold shares of the entity's stock.
C. The entity distributes financial forecasts to financial analysts that predict conservative operating results.
D. Management is interested in maintaining the entity's earnings trend by using aggressive accounting practices.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. If the auditor becomes aware of management's interest in maintaining the entity's earnings trend by using aggressive accounting practices, this would be indicative of an attitude conducive to fraud. Choice "a" is incorrect. Management purchase of company stock does not necessarily indicate an increased risk of fraud.
Choice "b" is incorrect. Sale by board members of company stock does not necessarily indicate an increased risk of fraud.
Choice "c" is incorrect. Prediction of conservative operating results is not a fraud risk factor; commitment to aggressive or unrealistic predictions would more likely be indicative of fraud risk.

QUESTION 464
Which of the following characteristics most likely would heighten an auditor's concern about the risk of material misstatement arising from fraudulent financial reporting?

A. There is a lack of interest by management in maintaining an earnings trend.
B. Computer hardware is usually sold at a loss before being fully depreciated.
C. Management had frequent disputes with the auditor on accounting matters.
D. Monthly bank reconciliations usually include several large checks outstanding.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Frequent disputes between management and the auditor is a fraud risk factor that would heighten an auditor's concern about the risk of material misstatement arising from fraudulent financial reporting.
Choice "a" is incorrect. Management's excessive interest in maintaining or increasing the stock price and earnings trend is a fraud risk factor, but management's lack of interest in maintaining an earnings trend would not constitute a fraud risk factor.
Choice "b" is incorrect. Since depreciation does not adjust an asset to market value, the sale of computer hardware at a loss before being fully depreciated is not unusual and would not heighten an auditor's concern.
Choice "d" is incorrect. Bank reconciliations with outstanding checks are not unusual and would not heighten the auditor's concern about the risk of material misstatement. Outstanding checks can also be verified with the bank at a later date, when the checks clear.

QUESTION 465
Which of the following statements is correct regarding the auditor's consideration of the possibility of illegal acts by clients?

A. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that no illegal acts have been committed by clients.
B. The auditor's training, experience, and understanding of the client should be used to provide a basis for the determination as to whether illegal acts have

occurred.

C. If specific information concerning an illegal act comes to the auditor's attention, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.
D. If an illegal act has occurred, the auditor should express a qualified opinion or an adverse opinion on the financial statements taken as a whole.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. If specific information concerning a possible illegal act comes to the auditor's attention, the auditor should apply additional audit procedures to determine whether an illegal act has in fact occurred.
Choice "a" is incorrect. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. This is a different level of assurance than stating that "no illegal acts" have been committed by clients, since it is possible for an immaterial illegal act (for example a theft of a few dollars from the petty cash fund) to occur and not be identified by the auditor.
Choice "b" is incorrect. The auditor's training, experience, and understanding of the client may not be sufficient to provide a basis for the determination as to whether illegal acts (especially indirect effect illegal acts) have occurred. Choice "d" is incorrect. If an illegal act has occurred, but the act has been properly accounted for and/or disclosed, there would be no need to express a qualified opinion or an adverse opinion.

QUESTION 466
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 information system relevant to financial reporting.
D. Determine whether controls operated effectively to prevent or detect material misstatements.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The auditor is required to document key elements of the understanding of the entity and its environment, including each of the components

of internal control.
Choice "b" is incorrect. Auditors are not required to search for significant deficiencies in the operation of internal control. They are merely required to report such conditions discovered during the audit to those charged with governance.
Choice "c" is incorrect. Auditors are not required to perform tests of controls unless they plan to place reliance on a particular control. Since auditors are not required to rely on the client's controls, tests of controls are generally not required. Choice "d" is incorrect. The auditor generally is not required to determine whether the client's controls operated effectively to prevent or detect material errors. Such determination would only be required for controls on which the auditor plans to rely.

QUESTION 467
The audit plan usually cannot be finalized until the:

A. Consideration of the entity's internal control has been completed.
B. Representation letter has been signed by the client.
C. Significant deficiencies in internal control have been communicated to those charged with governance.
D. Search for unrecorded liabilities has been performed and documented.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The auditor should obtain a sufficient understanding of the entity and its environment, including its internal control, to plan the audit of the entity's financial statements.
Choice "b" is incorrect. The representation letter is not obtained until the end of the audit.
Choice "c" is incorrect. Informing those charged with governance of significant deficiencies in internal control generally occurs during or at the completion of the audit. It is not required before completion of the audit plan.
Choice "d" is incorrect. The search for unrecorded liabilities typically takes places after year-end, while the audit plan is prepared during planning. Information obtained from the search is not needed to finalize the audit plan.

QUESTION 468
The primary objective of procedures performed to obtain an understanding of the entity and its environment is to provide an auditor with:

A. Knowledge necessary for risk assessment and audit planning.
B. Audit evidence to use in assessing inherent risk.
C. A basis for issuing an opinion on the financial statements.
D. An evaluation of the consistency of application of management's policies.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The auditor should obtain an understanding of the entity and its environment sufficient to assess the risk of material misstatement and to design and perform further audit procedures. Choice "b" is incorrect. Assessing inherent risk is not the primary objective of obtaining an understanding of the entity and its environment.
Choice "c" is incorrect. Obtaining an understanding of the entity and its environment is not a sufficient basis for issuing an audit opinion.
Choice "d" is incorrect. Procedures performed to gain an understanding of the entity and its environment would not ordinarily test the consistency of the application of management's policies. If the auditor intends to rely on a control, its consistency in application would then be tested.

QUESTION 469
If an auditor's risk assessment is based on the effective operation of controls, the auditor will likely:

A. Apply analytical procedures to both financial data and nonfinancial information to detect conditions that may indicate weak controls.
B. Perform tests of details of transactions and account balances to identify potential errors and fraud.
C. Identify specific internal controls that are likely to detect or prevent material misstatements.
D. Document that the additional audit effort to perform tests of controls exceeds the potential reduction in substantive testing.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Assessing risk based on the effective operation of controls involves (1) identifying specific internal controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions, and (2) performing tests of such controls to evaluate their effectiveness.
Choice "a" is incorrect. Analytical procedures are used for planning purposes, as substantive tests, or as a final overall review. They are not used to support a risk assessment based on the effective operation of controls.
Choice "b" is incorrect. Tests of details of transactions and account balances to identify potential errors and fraud are substantive tests. They are not used to support a risk assessment based on the effective operation of controls.
Choice "d" is incorrect. The auditor may not assess risk based on the effective operation of controls unless tests of controls are performed. However, if the audit effort required to perform tests of controls exceeds the potential reduction in substantive testing, tests of controls will not be performed because doing so would

reduce audit efficiency.

QUESTION 470
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 client's activities.
C. Indicate whether control activities are operating effectively.
D. Reduce the need to observe client's employees performing routine tasks.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. An advantage of using systems flowcharts to document internal information is that flowcharts provide a visual depiction of clients' activities.
Choice "a" is incorrect. Identification of internal control weaknesses requires the understanding, testing, and evaluation of controls. Either flowcharts or questionnaires can be used to obtain an understanding of internal control for this purpose.
Choice "c" is incorrect. Determining whether control activities are operating effectively requires tests of controls, and generally cannot be determined based on a flowchart or a questionnaire.
Choice "d" is incorrect. Observing tasks being performed (routine or otherwise) are tests of controls. The need to perform tests of controls is not affected by the form of audit documentation selected.

QUESTION 471
An auditor's risk assessment is based on the assumption that controls are operating effectively. Which of the following was not a step in making this assessment?

A. Evaluate the effectiveness of the internal controls with tests of controls.
B. Obtain an understanding of the entity's accounting system and control environment.
C. Perform tests of details of transactions to detect material misstatements in the financial statements.
D. Consider whether control activities can have a pervasive effect on financial statement assertions.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Tests of details of transactions are used to detect material misstatements in the financial statements after the auditor has assessed risk, not as part of making this assessment.
Choice "a" is incorrect. Tests of controls are required to support the auditor's assumption that controls are operating effectively.
Choice "b" is incorrect. Obtaining an understanding of each of the five components of internal control is required before making an assessment of control risk. The entity's accounting system (part of the information and communication component) and control environment are part of the five components.
Choice "d" is incorrect. Considering whether control activities can have a pervasive effect on financial statement assertions is part of the auditor's risk assessment process.

QUESTION 472
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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Observation and inspection may be used to evaluate the design of controls.
Observation of entity personnel applying control activities is a procedure that would likely provide evidence about the design of the activities.
Choice "a" is incorrect. Reperforming control activities provides the auditor with evidence about the operating effectiveness of specific control activities, not the design effectiveness.
Choice "b" is incorrect. Analytical procedures would not provide the auditor with evidence about the design of specific control activities.
Choice "c" is incorrect. Vouching a sample of transactions directly related to control activities would not provide the auditor with evidence about the design of specific control activities.

QUESTION 473
Management philosophy and operating style most likely would have a significant influence on an entity's control environment when:

A. The internal auditor reports directly to management.
B. Management is dominated by one individual.
C. Accurate management job descriptions delineate specific duties.
D. Those charged with governance actively oversee the financial reporting process.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Management philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following: management's approach to taking and monitoring business risks, management's attitudes and actions toward financial reporting, and management's attitudes toward information processing and accounting functions and personnel. These characteristics are more likely to have a significant influence on the control environment when management is dominated by one individual, since there will be few alternative viewpoints presented.
Choice "a" is incorrect. The internal audit function is part of the monitoring component of internal control, not part of the control environment. If the internal auditor reports directly to management, this would reduce their objectivity and perhaps make the monitoring function less effective, but it would have minimal impact on the control environment.
Choice "c" is incorrect. Accurate management job descriptions would not change the influence that management philosophy and operating style have on the entity's control environment.
Choice "d" is incorrect. The involvement of those charged with governance in the reporting process would tend to moderate or offset the influence that management philosophy and operating style have on the entity's control environment.

QUESTION 474
Which of the following is a management control method that most likely could improve management's ability to supervise company activities effectively?

A. Monitoring compliance with internal control requirements imposed by regulatory bodies.
B. Limiting direct access to assets by physical segregation and protective devices.
C. Establishing budgets and forecasts to identify variances from expectations.
D. Supporting employees with the resources necessary to discharge their responsibilities.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:

Section: Volume C

Choice "c" is correct. The use of budgets and forecasts to identify variances improves managers' ability to supervise company activities. Variances from budgets serve as signals to managers that a potential problem exists. Choice "a" is incorrect. Compliance with internal controls mandated by a regulatory body may be necessary, but would not necessarily enhance the ability of a manager to supervise company activities.
Choice "b" is incorrect. Limiting access to assets serves as a deterrent to employee theft, but does not really improve managers' ability to supervise company activities. Choice "d" is incorrect. Supporting employees with adequate resources is important, but it does not necessarily increase the supervisory capability of a manager.

QUESTION 475
In obtaining an understanding of a manufacturing entity's internal control concerning 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 controls over inventory.
D. Perform test counts of inventory during the entity's physical count.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. This question-asks about internal control. Review of descriptions of controls would typically be performed while gaining an understanding of an entity's internal control (for any system or cycle, not just inventory).
Choice "a" is incorrect. Analysis of inventory ratios is an analytical procedure, which is not used to gain an understanding of internal control.
Choice "b" is incorrect. Analytical procedures are used in planning the audit, as a substantive test, or for final overall review; they are not used to gain an understanding of internal control. Choice "d" is incorrect. Observation of physical inventory counts is a substantive test, not a procedure used to gain an understanding of internal control.

QUESTION 476
The overall attitude and awareness of those charged with governance (i.e., an entity's board of directors) concerning the importance of internal control usually is reflected in its:

A. Computer-based controls.
B. System of segregation of duties.

C. Control environment.
D. Safeguards over access to assets.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The control environment reflects the overall attitude, awareness and actions of those charged with governance (i.e., the board of directors, management, owners, and others) concerning the importance of control and its emphasis in the entity.
Choice "a" is incorrect. Computer-based controls are a control activity. The overall attitude and awareness of those charged with governance is not a control activity.
Choice "b" is incorrect. A system of segregation of duties is a control activity. The overall attitude and awareness of those charged with governance is not a control activity.
Choice "d" is incorrect. Safeguards over access to assets is a control activity. The overall attitude and awareness of those charged with governance is not a control activity.

QUESTION 477
In an audit of financial statements, an auditor's primary consideration regarding internal control is whether the control:

A. Reflects management's philosophy and operating style.
B. Affects management's financial statement assertions.
C. Provides adequate safeguards over access to assets.
D. Enhances management's decision-making processes.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Assessing control risk is the process of evaluating the effectiveness of an entity's internal control in preventing or detecting material misstatements in the financial statements.
Choice "a" is incorrect. Management's philosophy and operating style are considered a part of the control environment. They are not the primary consideration in

evaluating internal control.
Choice "c" is incorrect. Providing adequate safeguards over access to assets is a type of control activity, but it is not the auditor's primary consideration regarding internal control.
Choice "d" is incorrect. Policies and procedures concerning the effectiveness, economy, and efficiency of certain management decision-making processes are not relevant to the auditor's consideration of internal control.

QUESTION 478
The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that:

A. Tests of controls may fail to identify procedures relevant to assertions.
B. Material misstatements may exist in the financial statements.
C. Specified controls requiring segregation of duties may be circumvented by collusion.
D. Entity policies may be overridden by senior management.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that material misstatements exist in the financial statements. Choice "a" is incorrect. Tests of controls are used to assess control risk, not to identify procedures relevant to assertions. Choice "c" is incorrect. Collusion represents an inherent limitation in the effectiveness of internal control. The auditor does not assess control risk to evaluate such limitations. Choice "d" is incorrect. Management override of policies represents an inherent limitation in the effectiveness of internal control. The auditor does not assess control risk to evaluate such limitations.

QUESTION 479
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. The audit committee is active in overseeing the entity's financial reporting policies.
B. External policies established by parties outside the entity affect its accounting practices.
C. Management is dominated by one individual who is also a shareholder.
D. Internal auditors have direct access to those charged with governance.

Correct Answer: C
Section: Volume C

Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. When management is dominated by one individual who is also a shareholder, there may not be any factors to moderate management's aggressive style. In such situations, management's style is likely to have a strong impact on the control environment.
Choice "a" is incorrect. An active audit committee tends to moderate management's aggressive reporting style.
Choice "b" is incorrect. External policies established by outside parties would tend to moderate management's aggressive reporting style. Choice "d" is incorrect. An effective internal audit function would tend to moderate management's aggressive reporting style.

QUESTION 480
When obtaining an understanding of an entity's internal controls, an auditor should concentrate on the substance of the controls rather than their form because:

A. The procedures may be operating effectively but may not be documented.
B. Management may establish appropriate procedures but not enforce compliance with them.
C. The procedures may be so inappropriate that no reliance is contemplated by the auditor.
D. Management may implement procedures whose costs exceed their benefits.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. "Substance over form" concerns relate to controls that appear on the surface to exist but in reality are not operating effectively. When obtaining an understanding of a client's internal controls, an auditor should concentrate on the substance of controls rather than the form because even when appropriate procedures are established, management may not enforce compliance.
Choice "a" is incorrect. "Substance over form" concerns relate to controls that appear on the surface to exist but in reality are not operating effectively. Procedures that are operating effectively, even if they are not documented, do not illustrate this situation.
Choice "c" is incorrect. The auditor should first obtain an understanding of the controls in order to determine whether the controls are appropriate or inappropriate. The auditor would not focus at all on controls deemed to be inappropriate. Choice "d" is incorrect. While the cost-benefit of internal control is of concern to management in the design of the system, it plays no role in the auditor's attempt to gain an understanding of internal controls.

QUESTION 481
When an auditor is to conduct an audit of a service organization, what considerations should the auditor make in the planning stages regarding internal controls of the organization?

A. The auditor should assess the control risk before obtaining an understanding of internal controls.
B. The auditor should obtain an understanding of the entity's internal controls after performing substantive procedures.
C. The auditor should obtain an understanding of the effect of the user organization upon the service organization.
D. The auditor should be engaged to perform agreed-upon procedures.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. In some situations, the controls at a service organization are designed under the assumption that there will be certain complementary controls implemented by user organizations. These complementary controls should be included in the description of controls. The service auditor should obtain an understanding of such situations, in order to evaluate whether the complementary controls are necessary to achieve stated control objectives.
Choice "a" is incorrect. The auditor would need to understand controls before assessing their operating effectiveness.
Choice "b" is incorrect. Substantive procedures are not performed by a service auditor, who is either reporting on controls placed in operation, or on controls placed in operation and their operating effectiveness. Remember that a service auditor's engagement is not the same as an audit of financial statements.
Choice "d" is incorrect. Although a service auditor's engagement differs from an audit of financial statements, it is performed in accordance with the general standards as well as the relevant fieldwork and reporting standards. It is not considered to be an agreed-upon procedures engagement, as the auditor has not been engaged by the service organization to issue a report of findings based on specific, agreed upon procedures.

QUESTION 482
Proper segregation of duties reduces the opportunities to allow any employee to be in a position to both:

A. Journalize cash receipts and disbursements and prepare the financial statements.
B. Monitor internal controls and evaluate whether the controls are operating as intended.
C. Adopt new accounting pronouncements and authorize the recording of transactions.
D. Record and conceal fraudulent transactions in the normal course of assigned tasks.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Proper segregation of duties reduces the opportunities for any individual to both perpetrate and conceal errors or fraud.
Choice "a" is incorrect. Proper segregation of duties typically involves assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of the related assets. Since journalizing cash receipts and disbursements and preparing the financial statements are both recordkeeping functions, this would not be a violation of proper segregation of duties.
Choice "b" is incorrect. Monitoring internal controls and evaluating whether those controls are operating as intended would properly be performed by one person. Combining these functions does not violate the concept of proper segregation of duties, since it does not encompass an inappropriate combination of authorization, record keeping, and custodial functions.
Choice "c" is incorrect. Proper segregation of duties typically involves assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of the related assets. Since adopting new accounting pronouncements and authorizing the recording of transactions are both authorization functions, this would not be a violation of proper segregation of duties.

QUESTION 483
Management's emphasis on meeting projected profit goals most likely would significantly influence an entity's control environment when:

A. Internal auditors have direct access to the entity's board of directors.
B. A significant portion of management compensation is represented by stock options.
C. External policies established by parties outside the entity affect accounting policies.
D. Those charged with governance are active in overseeing the entity's financial reporting policies.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Management's emphasis on meeting projected profit goals would significantly influence an entity's control environment when a significant portion of management compensation is represented by stock options, because management would then have a personal interest that might be at odds with accurate financial reporting.
Choice "a" is incorrect. An effective internal audit function would tend to moderate management's emphasis on meeting projected profit goals, and would therefore tend to dampen the effect on the control environment.
Choice "c" is incorrect. External policies established by outside parties would tend to moderate management's emphasis on meeting projected profit goals, and would therefore tend to dampen the effect on the control environment.
Choice "d" is incorrect. Active participation of those charged with governance would tend to moderate management's emphasis on meeting projected profit goals, and would therefore tend to dampen the effect on the control environment.

QUESTION 484
Which of the following factors would most likely be considered an inherent limitation to an entity's internal control?

A. The complexity of the information processing system.
B. Human judgment in the decision making process.
C. The ineffectiveness of the board of directors.
D. The lack of management incentives to improve the control environment.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Human error is an inherent limitation in internal control, because even a properly designed and operating internal control system cannot prevent errors in the use of information provided by the system.
Choice "a" is incorrect. The complexity of the information processing system is not an inherent limitation of internal control, because controls can be adequately designed to take such complexity into account.
Choice "c" is incorrect. An ineffective board of directors is a weakness in internal control, but it is one that could and should be corrected. It is not an inherent limitation of internal control.
Choice "d" is incorrect. Lack of appropriate incentives to improve the control environment is a weakness in internal control, but it is one that could and should be corrected. It is not an inherent limitation of internal control.

QUESTION 485
In planning the audit, the auditor obtains a sufficient understanding of the existing internal control. Which one of the following is not among the auditor's primary objectives for obtaining such knowledge?

A. Identify types of material misstatements.
B. Consider the factors that affect the risk of material misstatement.
C. Make constructive suggestions to the client for improvement.
D. Design effective substantive tests.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Making constructive suggestions to the client is not a primary objective for obtaining an understanding of internal control, although it may be a desirable by-product of an audit engagement.
Choices "a", "b", and "d" are incorrect, as the following are primary internal control planning objectives of an auditor in a financial statement audit:
A. Identify types of potential material misstatements.
B. Consider factors that affect the risk of material misstatements.
D. Design effective substantive tests.

QUESTION 486
Which of the following components (elements) of an entity's internal control includes the development of personnel manuals documenting employee promotion and training policies?

A. Monitoring.
B. Control environment.
C. Information and communication system.
D. Quality control system.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The control environment element of an entity's internal control relates to the tone of the organization, which includes human resource policies and practices.
Choice "a" is incorrect. Monitoring activities assess the quality of internal control performance over time.
Choice "c" is incorrect. The information and communication system relates to the identification, capture, and exchange of information. Choice "d" is incorrect. A quality control system is not a component of an entity's internal control.

QUESTION 487
Which of the following statements about internal control is correct?

A. Properly maintained internal control reasonably ensures that collusion among employees cannot occur.
B. The establishment and maintenance of internal control is an important responsibility of the internal auditor.
C. Exceptionally strong internal control is enough for the auditor to eliminate substantive tests on a significant account balance.
D. The cost-benefit relationship is a primary criterion that should be considered in designing internal control.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The concept of reasonable assurance recognizes that the cost of an entity's internal control should not exceed the benefits that are expected to be derived. The cost-benefit relationship is a primary criterion that should be considered in designing internal control.
Choice "a" is incorrect. Even a properly maintained system of internal control is unable to reasonably ensure that collusion among employees cannot occur.
Choice "b" is incorrect. Establishing and maintaining internal control is the responsibility of management - - not the internal auditor.
Choice "c" is incorrect. An exceptionally strong internal control that has been tested and can be relied upon by the auditor will allow the auditor to reduce (but not eliminate) substantive tests on significant account balances.

QUESTION 488
An auditor uses the knowledge provided by the understanding of internal control and the final assessed risk of material misstatement primarily to determine the nature, timing, and extent of the:

A. Attribute tests.
B. Compliance tests.
C. Tests of controls.
D. Substantive tests.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. An auditor uses the knowledge provided by the understanding of internal control and the final assessed risk of material misstatement primarily to determine the nature, timing, and extent of the substantive tests to be performed.
Choices "a", "b", and "c" are incorrect. Attribute tests, compliance tests, and tests of controls are all tests that assist the auditor in assessing control risk and determining the final assessed risk of material misstatement, not the other way around.

QUESTION 489
An auditor would most likely be concerned with internal controls that provide reasonable assurance about the:

A. Efficiency of management's decision-making process.
B. Appropriate prices the entity should charge for its products.
C. Methods of assigning production tasks to employees.
D. Entity's ability to process and summarize financial data.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. An auditor would most likely be concerned with internal controls that provide reasonable assurance about the entity's ability to process and summarize financial data.
Choice "a" is incorrect. The auditor is primarily concerned with the fair presentation of the financial statements, and would not particularly care about the efficiency of management's decision-making process.
Choice "b" is incorrect. The auditor is primarily concerned with the fair presentation of the financial statements. Pricing decisions made by management would not be of much concern, as long as the related transactions were appropriately valued and recorded.
Choice "c" is incorrect. The auditor is primarily concerned with the fair presentation of the financial statements. How the client assigns tasks to its employees generally is of little concern to the auditor.

QUESTION 490
An auditor's primary consideration regarding an entity's internal control is whether the controls:

A. Affect the financial statement assertions.
B. Prevent management override.
C. Relate to the control environment.
D. Reflect management's philosophy and operating style.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. An auditor's primary consideration regarding an entity's internal control is whether the controls affect the financial statement assertions (to

evaluate the risk that a material misstatement may exist in the financial statements).
Choice "b" is incorrect. An inherent limitation of an entity's internal control is that its effectiveness can be reduced by management override, but whether this occurs or not is not the auditor's primary consideration.
Choice "c" is incorrect. The control environment is a component of internal control, and the auditor needs to understand it, but it is not the auditor's primary consideration.
Choice "d" is incorrect. An auditor needs to determine how management's philosophy and operating style affect internal control, but it is not the auditor's primary consideration.

QUESTION 491
The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the:

A. Factors that raise doubts about the auditability of the financial statements.
B. Operating effectiveness of internal control activities.
C. Risk that material misstatements exist in the financial statements.
D. Possibility that the nature and extent of substantive tests may be reduced.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that material misstatements exist in the financial statements.
Choice "a" is incorrect. Sometimes risk assessment procedures may raise doubts about the auditability of the financial statements, but this is not the ultimate purpose of assessing control risk.
Choice "b" is incorrect. The auditor is required to obtain knowledge about the operating effectiveness of internal controls, if his or her risk assessment is based on the effective operation of controls. Obtaining such knowledge, however, is not the ultimate purpose of assessing control risk.
Choice "d" is incorrect. Although the nature and extent of substantive tests may be reduced based on the results of the control risk assessment, this is not the ultimate purpose of assessing control risk.

QUESTION 492
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. No - Yes. In obtaining an understanding of an entity's internal control, an auditor is required to obtain knowledge about the design of controls and whether they have been implemented. The auditor is not required to obtain knowledge about the "operating effectiveness of controls" as part of obtaining an understanding of internal control. Choices "a", "c", and "d" are incorrect, per the above explanation.

QUESTION 493
Internal control includes which of the following components:

	Control Environment	Monitoring	Information and Communication Systems	Risk Assessment
A.	Yes	No	No	Yes
B.	No	No	Yes	Yes
C.	Yes	Yes	Yes	Yes
D.	No	Yes	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Yes - Yes - Yes - Yes. In addition, "control activities" rounds out the five components of internal control. Choices "a", "b", and "d" are incorrect, per the above.

QUESTION 494
Which of the following statements about internal control is correct?

A. There is no relationship between an entity's objectives and the components of internal control.
B. Internal control is relevant to the entire entity, or to any of its operating units or business functions.
C. All of the entity's objectives and related internal controls are relevant to an audit of the entity's financial statements.
D. An understanding of internal control relevant to each of the entity's operating units and business functions is necessary.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Internal control is relevant to the entire entity, or to any of its operating units or business functions.
Choice "a" is incorrect. There is a direct relationship between:
1. An entity's objectives, which are what the entity strives to achieve, and
2. The components of internal control, which represent what is needed to achieve the objectives.
Choice "c" is incorrect. Not all of the entity's objectives and related controls are relevant to an audit of the entity's financial statements.
Choice "d" is incorrect. Although internal control is relevant to each of the entity's operating units and business functions, an understanding of internal control relevant to each operating unit and business function may not be necessary to plan and perform an efficient audit.

QUESTION 495
Objectives of an entity include:

	Information and Communication Systems	*Reliable Financial Reporting*	*Effective and Efficient Operations*
A.	Yes	Yes	Yes
B.	No	Yes	No
C.	Yes	No	No
D.	No	Yes	Yes

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. No - Yes - Yes. An entity's objectives consist of financial reporting, operations, and compliance. Information and communication is a component of internal control, not an objective. Choices "a", "b", and "c" are incorrect, per the above.

QUESTION 496
Internal control over safeguarding of assets may include controls relating to:

	Financial Reporting Objectives	Operations Objectives	Compliance Objectives
A.	Yes	Yes	No
B.	No	Yes	Yes
C.	Yes	No	No
D.	No	No	Yes

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Yes - Yes - No.
Internal control over safeguarding of assets may relate to both financial reporting and operations objectives. For example, controls related to financial reporting might include: 1. Use of a lockbox system for collecting cash, or
2. Passwords for limiting access to accounts receivable data files.
Controls related to operations might include controls to prevent the excess use of materials in production. Internal control over safeguarding of assets generally would not relate to compliance objectives. (Note that the auditor generally would only be concerned with the controls relevant to financial reporting, but this question-does not ask which controls are important to the auditor.) Choices "b", "c", and "d" are incorrect, based on the above explanation.

QUESTION 497
The responsibility to establish, maintain and monitor internal controls is that of the entity's:

A. Accounting department.
B. Internal auditor.
C. Management.
D. External auditor.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The entity's management is responsible for establishing, maintaining, and monitoring the entity's internal controls, considering whether those controls are operating as intended, and modifying controls as conditions change.
Choice "a" is incorrect. The accounting department is not responsible for establishing, maintaining, and monitoring internal controls.
Choice "b" is incorrect. The internal auditors contribute to the monitoring of the entity's activities, but are not responsible for establishing or maintaining them.
Choice "d" is incorrect. The (external) auditor is required to obtain sufficient knowledge of internal control, but is not responsible for establishing, maintaining, and/or monitoring internal control.

QUESTION 498
Internal control is relevant to:

A. An entire entity.
B. An entity's operating units.
C. An entity's business functions.
D. All of the above.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Internal control is relevant to the entity, its operating units, and its business functions.
Choices "a", "b", and "c" are incorrect. Internal control is relevant to all parts of the entity, although not all controls may be relevant to a financial statement audit.

QUESTION 499
Which of the following is necessary in a financial statement audit?

A. An understanding of internal control relevant to each of an entity's operating units.
B. An understanding of internal control relevant to each of an entity's business functions.
C. An understanding of internal control relevant to an entity's financial reporting objective.
D. An understanding of internal control relevant to an entity's compliance objective.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. An understanding of internal control relevant to an entity's financial reporting objective is necessary as part of audit planning.
Choices "a" and "b" are incorrect. An understanding of internal control relevant to each of an entity's operating units and business functions may not always be necessary. Choice "d" is incorrect. Not all compliance objectives are relevant to an audit, since some are not related to financial reporting.

QUESTION 500
Which of the following controls is least likely to be relevant to a financial statement audit?

A. Procedures that prevent the excess use of materials in production.
B. Policies that relate to compliance with income tax regulations.
C. Use of computer passwords to limit access to data files.
D. Generation of production statistics used to evaluate variances.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Procedures to reduce inefficiency on the production line relate to operational objectives, and not necessarily to financial reporting objectives.
Choices "b", "c", and "d" are incorrect. Compliance with income tax regulations, use of passwords to limit data access, and generation of reports to facilitate variance analysis are all important controls related to financial reporting.

Group Exam B

QUESTION 1
If a budgetary reporting system provides adequate reports, but the reports are not analyzed and acted upon:

A. The control has been implemented and is operating effectively.
B. The control has been implemented but is not operating effectively.
C. The control has not been implemented and is not operating effectively.
D. The control has not been implemented but is operating effectively.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The fact that budgetary reports are being generated indicates that the control has been implemented. The control, however, does not provide any assurance regarding achievement of the entity's objectives, since the report is not being analyzed or acted upon. Accordingly, the control is not operating effectively.
Choices "a", "c", and "d" are incorrect. The control has been implemented but is not operating effectively per the explanation above.

QUESTION 2
In obtaining an understanding of a manufacturing entity's internal control concerning inventory balances, an auditor most likely would:

A. Review the entity's descriptions of inventory controls.
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.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. In obtaining an understanding of a manufacturing entity's internal control concerning inventory balances, an auditor would most likely review the entity's descriptions of inventory controls.
Choice "b" is incorrect. Performing test counts of inventory during the entity's physical count is a substantive procedure performed after obtaining an understanding of internal control.
Choice "c" is incorrect. Analyzing inventory turnover statistics to identify slow-moving and obsolete items is a substantive procedure performed after obtaining an understanding of internal control.
Choice "d" is incorrect. Analyzing monthly production reports to identify variances and unusual transactions is a substantive procedure performed after obtaining an understanding of internal control.

QUESTION 3
Which of the following services performed by another entity would not be considered to be part of the client's information system?

A. Processing of the client's accounting transactions by an electronic data processing service center.
B. Preparation of the client's financial statements by an outside accounting organization.
C. Initiation of the client's weekly payroll transactions by a payroll processing organization.
D. Sale (specifically authorized by the client) of investment securities by an external broker.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Services performed by another organization are not considered to be part of the client's information system if the services provided are limited to executing transactions that are specifically authorized by the client. Choice "a" is incorrect. A service organization's services are part of an entity's information system if they affect any of the following: How the entity's transactions are initiated; the accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of the entity's transactions; the accounting processing involved from the initiation of transactions to their inclusion in the financial statements, including electronic means used to transmit, process, maintain, and access information; and the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
Choice "b" is incorrect. As described more fully above, a service organization's services are part of an entity's information system if they affect the initiation, processing, or reporting of the entity's transactions. Choice "c" is incorrect. As described more fully above, a service organization's services are part of an entity's information system if they affect the initiation, processing, or reporting of the entity's transactions.

QUESTION 4
Which of the following is an inherent limitation in internal control?

A. Incompatible duties.
B. Lack of segregation of duties.

C. Faulty human judgment.
D. Lack of an audit committee.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Inherent limitations in internal control are limitations that exist despite implementation of appropriate controls. For example, faulty human judgment may result in errors in the design or use of internal controls. Choice "a" is incorrect. Assigning incompatible duties to a particular individual indicates a missing control, rather than an inherent limitation in internal control.
Choice "b" is incorrect. Lack of segregation of duties indicates a missing control, rather than an inherent limitation in internal control. Choice "d" is incorrect. Lack of an audit committee indicates a missing control, rather than an inherent limitation in internal control.

QUESTION 5
Quick Service Center processes the payroll for a variety of clients, including James Industries. Adams, CPA, is Quick's auditor, while Robinson, CPA, is the auditor for James Industries. Which of the following is not required of Adams?

A. Issuing a report that describes the scope and nature of the procedures performed.
B. Making inquiries regarding the professional reputation of Robinson, CPA.
C. Inquiring of management regarding subsequent events that might significantly affect user organizations such as James Industries.
D. Obtaining a letter of representation from the management of Quick Service Center.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The user auditor (Robinson) would make inquiries regarding the professional reputation of the service auditor (Adams), not vice versa.
Choice "a" is incorrect. The service auditor is required to describe the scope and nature of the procedures performed.
Choice "c" is incorrect. The service auditor is required to inquire of management regarding subsequent events that would have a significant effect on user organizations. Choice "d" is incorrect. The service auditor is required to obtain a management representation letter.

QUESTION 6
The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that:

A. Specific internal control activities are not operating as designed.
B. The collective effect of the control environment may not achieve the control objectives.
C. Tests of controls may fail to identify activities relevant to assertions.
D. Material misstatements may exist in the financial statements.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The auditor's ultimate purpose of assessing control risk is to evaluate the risk of financial statement misstatement.
Choice "a" is incorrect. The auditor's evaluation of whether or not specific internal control activities are operating as designed is part of his/her assessment of control risk; however, the ultimate purpose of making this assessment is to evaluate the risk of financial statement misstatement.
Choice "b" is incorrect. The auditor's evaluation of the collective effect of the control environment is part of his/her assessment of control risk; however, the ultimate purpose of making this assessment is to evaluate the risk of financial statement misstatement.
Choice "c" is incorrect. Tests of controls are not used to identify activities relevant to assertions. Tests of controls are used to evaluate the operating effectiveness of internal control in preventing or detecting material misstatements.

QUESTION 7
An auditor's primary consideration in evaluating controls is whether specific controls:

A. Affect financial statement assertions.
B. Can be classified into one of the five internal control components.
C. Improve the efficiency of the client's operations.
D. Reduce detection risk to a sufficiently low level.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. An auditor's primary consideration in evaluating controls is whether specific controls affect financial statement assertions, since ultimately the auditor must render an opinion on whether those assertions are fairly stated. Choice "b" is incorrect. The five components of internal control provide a useful framework for the auditor to evaluate the impact of such controls on an audit, but such classification is not the auditor's primary consideration.
Choice "c" is incorrect. Although a proper system of internal control may improve the client's operational efficiency, it is not a primary consideration for the auditor.
Choice "d" is incorrect. The auditor controls detection risk by varying the nature, timing, and extent of substantive tests. Whether or not a proper system of controls is in place affects control risk, not detection risk.

QUESTION 8
An auditor confirmed accounts receivable as of an interim date, and all confirmations were returned and appeared reasonable. Which of the following additional procedures most likely should be performed at year-end?

A. Send confirmations for all new customer balances incurred from the interim date to year-end.
B. Resend confirmations for any significant customer balances remaining at year-end.
C. Review supporting documents for new large balances occurring after the interim date, and evaluate any significant changes in balances at year-end.
D. Review cash collections subsequent to the interim date and the year-end.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. When auditing procedures are performed before year-end, additional procedures should be performed to extend the interim conclusions to year-enD. Large balances would be tested by reviewing supporting evidence, and significant changes in the balance would also be investigated.
Choice "a" is incorrect. The auditor would not send confirmations for all new customer balances, but instead would focus on those that appear material.
Choice "b" is incorrect. The purpose of performing tests at interim is to minimize the amount of work that needs to be performed at year end, to improve efficiency. If confirmations were sent at interim, and the auditor was satisfied with the results of that testing, there would be no reason to send additional confirmations. Rather, interim conclusions would be extended by focusing on any material changes in the account, including new, large balances.
Choice "d" is incorrect. Review of subsequent cash collections is a means of supporting a receivables balance when no confirmation response has been received. This procedure generally would not be performed as a means of extending interim conclusions to year-end.

QUESTION 9
In assessing control risk, an auditor ordinarily selects from a variety of techniques, including:

A. Inquiry and analytical procedures.
B. Reperformance and observation.

C. Comparison and confirmation.
D. Inspection and verification.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Tests of controls used in assessing control risk ordinarily include procedures such as inquiry of appropriate entity personnel, inspection of documents and reports indicating performance of the policy or procedure, observation of the application of the policy or procedure, and reperformance of the application of the policy or procedure by the auditor.
Choice "a" is incorrect. Analytical procedures are used in planning the audit, as a form of substantive testing, and as a final review. They are not useful in assessing control risk. Choice "c" is incorrect. Confirmation is a form of substantive testing, not a test of controls for assessing control risk. Choice "d" is incorrect. Verification is a form of substantive testing, not a test of controls for assessing control risk.

QUESTION 10
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 controls 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 the auditor's risk assessment is based on the effective operation of controls.
D. The lower the assessed level of control risk, the less assurance the evidence must provide that the controls are operating effectively.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Some risk assessment procedures performed to obtain an understanding of internal control may provide evidence about operating effectiveness, even if they were not intended for that purpose. This is possible because the procedures performed to achieve one objective may also provide evidence regarding the other.
Choice "b" is incorrect. Audit evidence that was obtained in prior audits about the effective design or operation of internal controls may be considered by the

auditor in assessing control risk in the current audit.
Choice "c" is incorrect. The auditor is always required to document the assessment of risk and the basis for the assessment.
Choice "d" is incorrect. The lower the assessed level of control risk (that is, the greater the reliance placed on the control), the more assurance the auditor must gather that the controls are operating effectively.

QUESTION 11
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.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Since control risk is assessed at a low level, tests of controls would be required to evaluate the effectiveness of the internal controls to support that assessed level. However, the need for some substantive tests of transactions is never eliminated.
Choice "a" is incorrect. Extensive tests of property and equipment balances would not typically be required when control risk is assessed at a low level.
Choice "b" is incorrect. Since control risk is to be assessed at a low level, tests of controls would be required. Analytical procedures would not be particularly useful, since property and equipment transactions are subject to management discretion.
Choice "d" is incorrect. Analytical procedures would not be particularly useful, since property and equipment transactions are subject to management discretion. Year-end balances may therefore be unpredictable.

QUESTION 12
After obtaining an understanding of the entity and its environment, including its internal control, an auditor decided to perform tests of controls. This is likely because:

A. The auditor's risk assessment is based on the effective operation of controls.
B. Evidence to support a reduction in control risk is not available.
C. An increase in the assessed level of control risk is justified for certain financial statement assertions.
D. There were many internal control weaknesses that could allow errors to enter the accounting system.

Correct Answer: A

Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. After obtaining an understanding the entity and its environment, including its internal control, the auditor may make a risk assessment that assumes controls are operating effectively. In such cases, the auditor performs tests of controls to obtain evidence supporting this assessment.
Choice "b" is incorrect. If evidence to support a reduction in control risk is not available, tests of controls would, by definition, not be possible.
Choice "c" is incorrect. When auditors decide to perform tests of controls, they have made a preliminary assessment that controls are operating effectively. Accordingly, the performance of tests of controls is not indicative of an increase in the assessed level of control risk.
Choice "d" is incorrect. When many internal control weaknesses are identified, the auditor would not be likely to perform tests of controls. The assessed level of control risk is increased, and more reliance would be placed on substantive tests as opposed to tests of controls.

QUESTION 13
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.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Tests of controls include such procedures as inspecting documentation, inquiry, observation, and reperformance.
Choice "b" is incorrect. Analytical procedures are used for planning purposes, as substantive tests, and as an overall final review, but they do not provide evidence about control risk. Choice "c" is incorrect. Calculation is used as a substantive test rather than as a test of controls. Choice "d" is incorrect. Confirmation represents a substantive test rather than a test of controls.

QUESTION 14
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 internal controls have been implemented.
C. Detect material misstatements in the account balances of the financial statements.
D. Evaluate whether internal controls operated effectively.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The objective of tests of details used as tests of controls is to evaluate whether an internal control operated effectively.
Choice "a" is incorrect. Tests of details of transactions would not typically be used to monitor the design and use of entity documents.
Choice "b" is incorrect. Tests of details of transactions would not typically be used to determine whether internal controls have been implemented.
Choice "c" is incorrect. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements.

QUESTION 15
An auditor wishes to perform tests of controls on a client's cash disbursements procedures. If the controls leave no audit trail of documentary evidence, the auditor most likely will test the procedures by:

A. Confirmation and observation.
B. Observation and inquiry.
C. Analytical procedures and confirmation.
D. Inquiry and analytical procedures.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. For internal controls which leave no audit trail of documentary evidence (e.g., segregation of duties), the auditor must use inquiry and observation to test the procedures. Choice "a" is incorrect. Confirmation is a substantive audit procedure not appropriate for tests of controls.
Choice "c" is incorrect. Analytical procedures and confirmation are substantive audit procedures not appropriate for tests of controls. Choice "d" is incorrect. Analytical procedures are substantive audit procedures not appropriate for tests of controls.

QUESTION 16
Which of the following audit techniques ordinarily would provide an auditor with the least assurance about the operating effectiveness of an internal control activity?

A. Inquiry of client personnel.
B. Inspection of documents and reports.
C. Observation of client personnel.
D. Preparation of system flowcharts.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Preparation of system flowcharts may aid in the auditor's understanding of internal control, but would not indicate whether controls were actually operating as designed. Choices "a", "b", and "c" are incorrect. Inquiry, inspection, observation (and reperformance) are all tests that may be used to evaluate the operating effectiveness of a control.

QUESTION 17
In an environment that is highly automated, an auditor determines that it is not possible to reduce detection risk solely by substantive tests of transactions. Under these circumstances, the auditor most likely would:

A. Perform tests of controls to support a lower level of assessed control risk.
B. Increase the sample size to reduce sampling risk and detection risk.
C. Adjust the materiality level and consider the effect on inherent risk.
D. Apply analytical procedures and consider the effect on control risk.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. When an entity transmits, processes, maintains, or accesses significant information electronically, factors unique to electronic processing may make it impractical or impossible to reduce detection risk to an acceptable level through substantive testing alone. In such cases, tests of controls should be performed.
Choices "b", "c", and "d" are incorrect. Certain factors unique to electronic processing may make it impractical or impossible to reduce detection risk to an acceptable level through substantive testing alone.
In such cases, tests of controls should be performed to address the increased potential for unauthorized access, the risks of insufficient paper-based audit evidence, and the fact that the appropriateness and sufficiency of evidence may be dependent to some extent on computerized controls. Simply expanding the sample size, adjusting materiality levels, or applying analytical procedures will not address these concerns.

QUESTION 18
Which of the following factors would least likely affect the extent of the auditor's consideration of the client's internal controls?

A. The amount of time budgeted to complete the engagement.
B. How frequently the control is performed.
C. The expected deviation rate from the control.
D. The extent to which other tests provide evidence about the same assertion.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The extent of the auditor's consideration of the client's internal controls is affected by a variety of factors, with the primary goal being to obtain a sufficient understanding the entity and its environment, including its internal control. The amount of time budgeted to complete the audit should not be a primary factor in determining the extent of consideration of the client's internal controls--if more time is needed to adequately consider internal control, then the budget should be revised.
Choice "b" is incorrect. How frequently the control is performed would affect the extent of the auditor's consideration of the client's internal controls.
Choice "c" is incorrect. The expected deviation rate would affect the extent of the auditor's consideration of the client's internal controls.
Choice "d" is incorrect. The extent to which other tests provide evidence about the same assertion would affect the extent of the auditor's consideration of the client's internal controls.

QUESTION 19
Which of the following statements about performing tests of controls to support a lower level of control risk is not true?

A. Observation by the auditor provides more assurance than inquiry alone.
B. Inquiry alone generally will support a conclusion for a lower assessed level of control risk.

C. Prior audits may be considered by the auditor in assessing control risk in the current audit.
D. An audit of financial statements is a cumulative process.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Inquiry alone generally will not support a conclusion for a lower assessed level of control risk.
Choices "a", "c", and "d" are incorrect, as the following are true:
A. Observation by the auditor provides more assurance than audit evidence obtained by inquiry alone.
C. Prior audits may be considered by the auditor in assessing control risk in the current audit.
D. An audit of financial statements is a cumulative process.

QUESTION 20
Which of the following audit techniques most likely would provide an auditor with the most assurance about the effectiveness of the operation of internal control?

A. Inquiry of client personnel.
B. Recomputation of account balance amounts.
C. Observation of client personnel.
D. Confirmation with outside parties.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Observation of client personnel provides an auditor with the most assurance about the effectiveness of the operation of an internal control.
Choice "a" is incorrect. Observation by the auditor provides more assurance than mere inquiry. Inquiry alone generally will not support a conclusion for a lower assessed level of control risk. Choices "b" and "d" are incorrect. Recomputation of account balance amounts and confirmation with outside parties are substantive tests of account balances, not tests of controls.

QUESTION 21
To obtain audit evidence about control risk, an auditor ordinarily selects tests from a variety of techniques, including:

A. Analysis.
B. Confirmation.
C. Reperformance.
D. Comparison.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Reperforming the application of relevant controls provides evidence regarding their operating effectiveness.
Choices "a", "b", and "d" are incorrect. Analysis, confirmation, and comparison are substantive tests of account balances, not tests of controls.

QUESTION 22
An auditor wishes to perform tests of controls on a client's cash disbursements procedures. If the control activities leave no audit trail of documentary evidence, the auditor most likely will test the procedures by:

A. Inquiry and analytical procedures.
B. Confirmation and observation.
C. Observation and inquiry.
D. Analytical procedures and confirmation.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. If an auditor wishes to perform a test of controls over a procedure that leaves no audit trail, then the auditor must use observation and inquiry to test the control. Choices "a", "b", and "d" are incorrect. Analytical procedures and confirmation are both substantive tests of balances, not tests of controls.

QUESTION 23
Audit evidence concerning 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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Audit evidence concerning proper segregation of duties ordinarily is best obtained by direct personal observation of the employees who apply control activities, especially if the control activities do not leave an audit trail. Choices "a" and "c" are incorrect. Preparation of a flowchart of duties performed by available personnel and reviewing job descriptions would assist the auditor in understanding internal control, but would provide no audit evidence regarding whether such procedures are actually functioning as documented.
Choice "b" is incorrect. Inquiring whether control activities operated consistently throughout the period would provide a good source of information, but inquiry alone is not as persuasive as direct personal observation.

QUESTION 24
An auditor may decide not to test controls related to certain assertions because the auditor believes:

A. Sufficient appropriate evidence to support the assertions is likely to be available.
B. Evaluating the effectiveness of controls is inefficient.
C. More emphasis on tests of controls than substantive tests is warranted.
D. Considering the relationship of assertions to specific account balances is more efficient.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. An auditor may decide to assess control risk at the maximum level for certain assertions because the auditor believes evaluating the effectiveness of controls is inefficient (i.e., it would be more efficient to test the assertions substantively).
Choice "a" is incorrect. Whether there is sufficient appropriate evidence to support the assertions relates to the auditability of the financial statements, whereas the decision whether or not to test controls relates to the audit strategy to be used (i.e., the balance between tests of controls and substantive testing).
Choice "c" is incorrect. The auditor will need to test controls if more emphasis on tests of controls than substantive tests is warranted.
Choice "d" is incorrect. The auditor will generally consider the relationship of assertions to specific account balances whether or not tests of controls are performed.

QUESTION 25
After performing risk assessment procedures, an auditor decided not to perform tests of controls. The auditor most likely decided that:

A. The available evidence obtained through tests of controls would not support an increased level of control risk.
B. A reduction in the assessed level of control risk is justified for certain financial statement assertions.
C. It would be inefficient to perform tests of controls that would result in a reduction in planned substantive tests.
D. The assessed level of inherent risk exceeded the assessed level of control risk.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. After performing risk assessment procedures, an auditor might decide not to perform tests of controls because it would be inefficient. In other words, the time required to perform tests of controls would be greater than the reduction in time spent on substantive testing.
Choice "a" is incorrect. The auditor might decide not to perform tests of controls if the available audit evidence obtained through those tests would not support a decrease (not increase) in the level of control risk.
Choice "b" is incorrect. A reduction in the assessed level of control risk can only be justified based on tests of controls. If the auditor decides not to perform tests of controls, the assessed level of control risk may not be reduced. Choice "d" is incorrect. The relationship of inherent risk to control risk does not determine the level of control testing to be performed.

QUESTION 26
For certain controls, such as segregation of duties, documentary evidence may not exist. An auditor would most likely test the controls by:

A. Reperformance and corroboration.
B. Observation and inquiry.

C. Inspection and vouching.
D. Confirmation and recomputation.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Controls for which documentary evidence does not exist, such as segregation of duties, would most likely be tested through observation and inquiry. Choice "a" is incorrect. Corroboration is a substantive test, which generally relies on documentary evidence.
Choice "c" is incorrect. Vouching is a substantive test, which generally requires documentary evidence.
Choice "d" is incorrect. Confirmation and recomputation are substantive tests, which generally depend on documentation.

QUESTION 27
As part of understanding internal control, an auditor is not required to:

A. Consider factors that affect the risk of material misstatement.
B. Ascertain whether internal controls have been implemented.
C. Identify the types of potential misstatements that can occur.
D. Obtain knowledge about the operating effectiveness of internal control.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. As part of understanding internal control, an auditor is not required to obtain knowledge about the operating effectiveness of controls. Operating effectiveness is evaluated later, and only for those controls on which the auditor plans to rely.
Choice "a" is incorrect. Considering factors that affect the risk of material misstatement is a part of understanding internal control.
Choice "b" is incorrect. Ascertaining whether internal controls have been implemented is required as part of obtaining an understanding of internal control.
Choice "c" is incorrect. Identifying the types of potential misstatements that can occur is part of understanding internal control.

QUESTION 28

Which of the following types of evidence would an auditor most likely examine to determine whether internal controls are operating as designed?

A. Confirmations of receivables verifying account balances.
B. Letters of representation corroborating inventory pricing.
C. Attorneys' responses to the auditor's inquiries.
D. Client records documenting the use of EDP programs.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The examination of client records documenting the use of EDP programs is a test of controls.
Choice "a" is incorrect. Confirmations of receivables verifying account balances is a substantive test, not a test of controls.
Choice "b" is incorrect. Obtaining letters of representation corroborating inventory pricing is a substantive test, not a test of controls. Choice "c" is incorrect. Attorneys' responses to the auditor's inquiries are part of a substantive test, not a test of controls.

QUESTION 29
Which of the following statements concerning control risk is correct?

A. Assessing control risk and obtaining an understanding of an entity's internal control may be performed concurrently.
B. Control risk may be assessed sufficiently high to eliminate substantive testing for significant transaction classes.
C. Control risk may be assessed sufficiently low to eliminate substantive testing for significant transaction classes.
D. When assessing control risk an auditor should not consider evidence obtained in prior audits about the operation of control activities.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Assessing control risk and obtaining an understanding of an entity's internal control may be performed concurrently.
Choices "b" and "c" are incorrect. Substantive testing can never be entirely eliminated for significant transaction classes.
Choice "d" is incorrect. A standard procedure in assessing control risk is to consider evidence obtained in prior audits about the operation of control activities.

QUESTION 30
Which of the following audit techniques most likely would provide an auditor with the most assurance about the effectiveness of the operation of internal control?

A. Confirmation with outside parties.
B. Inquiry of client personnel.
C. Recomputation of account balance amounts.
D. Observation of client personnel.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Observation of client personnel is the audit technique most likely to provide an auditor with the most assurance about the effectiveness of the operation of an internal control. This technique is especially effective for controls that leave little or no audit trail.
Choice "a" is incorrect. Confirmation with outside parties is a common substantive test (direct test of an account balance), not a procedure used to test controls.
Choice "b" is incorrect. While inquiry of client personnel can provide some evidence about the effectiveness of the operation of internal control, the auditor's direct observation generally provides greater assurance than does inquiry. Choice "c" is incorrect. Recomputation of account balance amounts is a substantive test, not a test of controls.

QUESTION 31
After obtaining an understanding of internal control and performing risk assessment procedures, an auditor decided not to perform tests of controls. The auditor most likely concluded that the:

A. Additional evidence to support a reduction in control risk was not cost-beneficial to obtain.
B. Assessed level of inherent risk exceeded the assessed level of control risk.
C. Internal control was properly designed and justifiably may be relied on.
D. Evidence obtainable through tests of controls would not support an increased level of control risk.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. When an auditor decides not to perform tests of controls, the auditor most likely concluded that the additional evidence to support a reduction in control risk was not cost-beneficial to obtain. In other words, the additional costs that would be incurred to support a lower assessed level of control risk would not be offset by the anticipated cost savings resulting from a lower level of substantive tests.
Choice "b" is incorrect. The assessed level of inherent risk (which is the susceptibility of an assertion to a material misstatement based upon the nature of the account balance or transaction class) exists independently from and bears no direct relationship to control risk.
Choice "c" is incorrect. Even if internal control is properly designed, it cannot justifiably be relied upon unless tests of controls are performed.
Choice "d" is incorrect. When performing additional tests of controls, an auditor is attempting to support a lower level of control risk, not higher.

QUESTION 32
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.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Tests of controls that do not provide documentary evidence (such as those controls related to segregation of duties) are generally tested by personal inquiry and observation by the auditor.
Choice "b" is incorrect. Test counts and cut-off procedures are effective substantive tests of inventory (existence assertion).
Choice "c" is incorrect. Analytical procedures and invoice recomputation are substantive tests performed by the auditor to gather evidence regarding management's assertion of valuation of the inventory. Choice "d" is incorrect. Document inspection and reconciliation generally is not helpful in testing segregation of duties, since even appropriate segregation often does not provide documentary evidence.

QUESTION 33
Which of the following is not part of obtaining an understanding of internal control?

A. Considering the types of misstatements that may occur in an entity's financial statements.
B. Determining whether internal controls are operating effectively.
C. Considering knowledge obtained from previous audits.

D. Determining the extent to which internal controls are computerized.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The auditor is not required to obtain knowledge about operating effectiveness as part of the understanding of internal control. This knowledge is obtained later, for specific controls on which the auditor plans to rely.
Choices "a", "c", and "d" are incorrect. During the planning phase of the audit, the auditor obtains an understanding of the internal control system by considering:
- The types of misstatements that may occur.
- The risk that misstatements may occur.
- Factors that influence the design of tests of controls and substantive tests.
- The assessment of inherent risk.
- Judgments about materiality.
- The complexity and sophistication of the entity's operations and systems.
- The use of manual vs. computerized control procedures.
Such knowledge may be obtained by appropriate inquiry, inspection, or observation. Knowledge may also be obtained based on previous experience with the client and/or an understanding of the industry in which the entity operates.

QUESTION 34
Audit evidence concerning segregation of duties ordinarily is best obtained by:

A. Performing tests of transactions that corroborate management's financial statement assertions.
B. Observing the employees as they apply control procedures.
C. Obtaining a flowchart of activities performed by available personnel.
D. Developing audit objectives that reduce control risk.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Audit evidence concerning segregation of duties ordinarily is best obtained by the auditor observing the employees as they apply control

procedures. Generally the auditor's direct, personal knowledge obtained through observation, inspection and physical examination is more persuasive than indirect information.
Choice "a" is incorrect. Performing tests of transactions that corroborate management's financial statement assertions would provide little audit evidence concerning segregation of duties.
Choice "c" is incorrect. Obtaining a flowchart of activities performed by available personnel may assist the auditor in understanding the design of the internal control system, but it provides no audit evidence regarding whether the segregation of duties is actually functioning as designed.
Choice "d" is incorrect. Developing audit objectives that reduce control risk provides no audit evidence regarding the segregation of duties.

QUESTION 35
After testing a client's internal control activities, an auditor discovers a number of significant deficiencies in the operation of a client's internal controls. Under these circumstances the auditor most likely would:

A. Issue a disclaimer of opinion about the internal controls as part of the auditor's report.
B. Increase the assessment of control risk and increase the extent of substantive tests.
C. Issue a qualified opinion of this finding as part of the auditor's report.
D. Withdraw from the audit because the internal controls are ineffective.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The auditor uses tests of controls to evaluate control risk. In situations where there are a number of significant deficiencies in the operation of the client's internal controls, the auditor would increase the assessment of control risk (and the risk of material misstatement) and revise substantive testing accordingly (for example, by increasing the extent of substantive tests).
Choice "a" is incorrect. An auditor is required to communicate significant deficiencies to management and those charged with governance, and a disclaimer of opinion on the effectiveness of controls would be included in this communication.
However, such disclaimer would not be part of the auditor's report on the financial statements.
Choice "c" is incorrect. Since the auditor's report provides an opinion on the financial statements (and not on internal control), significant deficiencies in internal control do not result in a qualified opinion.
Choice "d" is incorrect. The auditor need not withdraw from an audit simply because internal controls are ineffective, but rather would increase the assessment of control risk and revise substantive testing accordingly.

QUESTION 36
In which of the following circumstances is substantive testing of accounts receivable before the balance sheet date most appropriate?

A. The client has a new sales incentive program in place.

B. Internal controls during the remaining period are effective.
C. There is a high turnover of senior management.
D. It is a first engagement of a new client.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The higher the auditor's risk assessment, the closer to period end substantive procedures should be performed. Conversely, effective controls reduce control risk and reduce the risk of material misstatement, allowing more interim testing to occur.
Choice "a" is incorrect. A new sales incentive program results in an increase in the risk of material misstatement, making it less likely that interim testing will be performed.
Choice "c" is incorrect. High turnover of senior management results in an increase in the risk of material misstatement, making it less likely that interim testing will be performed.
Choice "d" is incorrect. In the first engagement of a new client, the auditor will have less knowledge of the client and therefore would be less inclined to utilize interim testing, which increases audit risk.

QUESTION 37
What is the most likely course of action that an auditor would take after determining that performing substantive tests on inventory will take less time than performing tests of controls?

A. Assess control risk at a low level.
B. Perform both tests of controls and substantive tests on inventory.
C. Perform only substantive tests on inventory.
D. Perform only tests of controls on inventory.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. If it would take less time to perform substantive tests than it would to perform tests of controls, and if there is no other reason to test

controls (i.e., if there is not a high degree of electronic processing), the auditor would not be likely to test controls.
Choice "a" is incorrect. In order to assess control risk at a low level, tests of controls would need to be performed. However, if it is more efficient to perform substantive tests, the auditor would not be likely to test controls.
Choice "b" is incorrect. If it would take less time to perform substantive tests than it would to perform tests of controls, and if there is no other reason to test controls (i.e., if there is not a high degree of electronic processing), the auditor would not be likely to test controls.
Choice "d" is incorrect. Substantive procedures are always be necessary for all assertions relevant to material transaction classes, account balances, and disclosures. Assuming inventory is material, tests of controls alone would not be sufficient.

QUESTION 38
Which of the following procedures would an auditor least likely perform before the balance sheet date?

A. Confirmation of accounts payable.
B. Observation of merchandise inventory.
C. Assessment of the risk of material misstatement.
D. Identification of related parties.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The auditor should consider whether the year-end balances of the particular asset or liability accounts that might be selected for interim examination are reasonably predictable with respect to amount, relative significance, and composition. Accounts payable is relatively difficult to predict because it may fluctuate at management's discretion.
Choice "b" is incorrect. The auditor should consider whether the year-end balances of the particular asset or liability accounts that might be selected for interim examination are reasonably predictable with respect to amount, relative significance, and composition. Inventory is relatively predictable with respect to amount, composition and relative significance.
Choice "c" is incorrect. During planning, the auditor is required to obtain an understanding of the entity and its environment, including its internal control, and to assess risk. Such preliminary planning is often conducted prior to the balance sheet date.
Choice "d" is incorrect. Audit testing at interim dates may permit early consideration of significant matters affecting the year-end financial statements, such as the identification of related parties.

QUESTION 39
Which of the following factors are included in an entity's control environment?

	Participation of those charged with governance	Management philosophy	Organizational structure
A.	Yes	Yes	No
B.	Yes	No	Yes
C.	No	Yes	Yes
D.	Yes	Yes	Yes

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Yes - Yes - Yes. An entity's control environment includes participation of those charged with governance, management's philosophy, and the organizational structure.

QUESTION 40
Which of the following are considered control environment factors?

	Assignment of authority and responsibility	Detection risk	Integrity and ethical values
A.	Yes	Yes	Yes
B.	No	Yes	No
C.	Yes	No	Yes
D.	No	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Yes - No - Yes. Control environment factors include:
1. Communication and enforcement of integrity and ethical values.
2. Commitment to competence.
3. Participation of those charged with governance.
4. Management's philosophy and operating style.
5. Organizational structure.
6. Assignment of authority, responsibility, and accountability.
7. Human resource policies and practices.
Choice "a" is incorrect. Detection risk is the risk that an auditor's procedures will lead to the conclusion that a material error does not exist in an account balance when, in fact, such error does exist. Choices "b" and "d" are incorrect, per the above.

QUESTION 41
Which of the following circumstances would most likely cause an auditor to suspect that material misstatements arising from fraud exist in a client's financial

statements?

A. Property and equipment are usually sold at a loss before being fully depreciated.
B. Significantly fewer responses to confirmation requests are received than expected.
C. Monthly bank reconciliations usually include several in-transit items.
D. Clerical errors are listed on an EDP-generated exception report.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Material fraud ("intentional" misstatements or omissions) may result from large amounts of fictitious accounts receivable. Receiving significantly fewer confirmation responses than expected implies some accounts receivable may be fictitious.
Choice "a" is incorrect. Selling property and equipment at a loss from book value is not unusual and would not necessarily be indicative of fraud.
Choice "c" is incorrect. Bank reconciliations typically include in-transit items (e.g., deposits in transit and outstanding checks), and this would not necessarily be indicative of fraud. Choice "d" is incorrect. Clerical errors listed on an exception report would be a control over data processing that would tend to minimize the risk of material misstatement.

QUESTION 42
Which of the following factors is most important concerning an auditor's responsibility to detect errors and fraud?

A. The susceptibility of the accounting records to intentional manipulations, alterations, and the misapplication of accounting principles.
B. The probability that unreasonable accounting estimates result from unintentional bias or intentional attempts to misstate the financial statements.
C. The possibility that management fraud, defalcations, and the misappropriation of assets may indicate the existence of illegal acts.
D. The risk that mistakes, falsifications, and omissions may cause the financial statements to contain material misstatements.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The most important factor concerning an auditor's responsibility to detect errors and fraud is the risk that mistakes, falsifications, and

omissions may cause the financial statements to contain material misstatements. Choice "a" is incorrect. The susceptibility of the accounting records to intentional manipulations, alterations, and the misapplication of accounting principles is something the auditor must consider, but it does not describe the auditor's responsibility to detect errors and fraud.
Choice "b" is incorrect. The probability that unreasonable accounting estimates result from unintentional bias or intentional attempts to misstate the financial statements is something the auditor must consider, but it does not describe the auditor's responsibility to detect errors and fraud.
Choice "c" is incorrect. The possibility that management fraud, defalcations, and the misappropriation of assets may indicate the existence of illegal acts is something the auditor must consider, but it does not describe the auditor's responsibility to detect errors and fraud.

QUESTION 43
Disclosure of fraud to parties other than a client's senior management, those charged with governance, or its 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 irregularities 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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:

Section: Volume C

Choice "d" is correct. The accountant may have a duty to disclose irregularities to all of the following outside parties:
Yes - The SEC when the client reports an auditor change.
Yes - A successor auditor when the successor makes appropriate inquiries.
Yes - A government funding agency from which the client receives financial assistance. Choices "a", "b", and "c" are incorrect, based on the above explanation.

QUESTION 44
Which of the following statements describes why a properly designed and executed audit may not detect a material misstatement due to fraud?

A. Audit procedures that are effective for detecting an unintentional misstatement may be ineffective for an intentional misstatement that is concealed through collusion.
B. An audit is designed to provide reasonable assurance of detecting material errors, but there is no similar responsibility concerning material misstatement due to fraud.
C. The factors considered in assessing control risk indicated an increased risk of intentional misstatements, but only a low risk of unintentional errors in the financial statements.
D. The auditor didn't consider factors influencing audit risk for account balances that have effects pervasive to financial statements taken whole.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. A properly designed and executed audit may not detect a material misstatement that is concealed through collusion. The auditor's responsibility is to design audit procedures that can reasonably be expected to detect material misstatements (errors and fraud) in the financial statements. Intentional misstatements that are concealed through collusion, however, are very difficult to detect, and generally the auditor is not responsible to discover them.
Choice "b" is incorrect. An audit is designed to provide reasonable assurance of detecting material misstatements (both errors and fraud).
Choice "c" is incorrect. If the factors considered in assessing control risk indicated an increased risk of intentional misstatements, a properly designed and executed audit would have taken the increased risk into consideration with additional audit procedures.
Choice "d" is incorrect. In a properly designed and executed audit, the auditor would consider factors influencing audit risk for account balances that have effects pervasive to the financial statements taken as a whole.

QUESTION 45
Which of the following circumstances most likely would cause an auditor to consider whether material misstatements exist in an entity's financial statements?

A. Supporting records that should be readily available are frequently not produced when requested.
B. Significant deficiencies in internal control previously communicated have not been corrected.
C. Clerical errors are listed on a monthly computer-generated exception report.
D. Differences are discovered during the client's annual physical inventory count.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Supporting records that should be readily available but are frequently not produced when requested would cause an auditor to consider whether material misstatements exist.
Choice "b" is incorrect. Failure to correct significant deficiencies in internal control may represent a conscious decision by management to accept that degree of risk because of cost or other considerations.
Although this is a fraud risk factor, the auditor is more likely to be concerned about missing audit evidence.
Choice "c" is incorrect. Clerical errors listed on a monthly computer-generated exception report would be a control over data processing that would tend to minimize the risk of material misstatement.
Choice "d" is incorrect. Differences being discovered during the client's annual physical inventory count is a common occurrence at most companies and would not necessarily indicate that a material misstatement exists.

QUESTION 46
The most likely explanation why the auditor's examination cannot reasonably be expected to bring all illegal acts by the client to the auditor's attention is that:

A. Illegal acts are perpetrated by management override of internal accounting controls.
B. Illegal acts by clients often relate to operating aspects rather than accounting aspects.
C. The client's system of internal accounting 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.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The audit should be designed to identify material misstatements due to illegal acts, but illegal acts that relate to operating aspects rather than accounting aspects may not directly affect the financial statements, and therefore they may be less likely to be discovered by the auditor.
Choice "a" is incorrect. The audit should be designed to identify material misstatements due to illegal acts, even if they are caused by management override of (its own) internal control.
Choice "c" is incorrect. The audit should be designed to identify material misstatements due to illegal acts, even when minimal substantive testing is performed by the auditor due to a very strong system of internal control.
Choice "d" is incorrect. The audit should be designed to identify material misstatements due to illegal acts, even when those illegal acts were perpetrated by the only person with access to both assets and the accounting records.

QUESTION 47
An auditor of a manufacturer would most likely question-whether that client has committed illegal acts if the client has:

A. Been forced to discontinue operations in a foreign country.
B. Been an annual donor to a local political candidate.
C. Failed to correct material weaknesses in internal accounting control that were reported after the prior year's audit.
D. Disclosed several subsequent events involving foreign operations in the notes to the financial statements.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Being forced to discontinue operations in a foreign country would cause the auditor of the manufacturer to question-whether that client has committed an illegal act.
Choice "b" is incorrect. Making political contributions to local politicians is not illegal. (Bribes are illegal.) Choice "c" is incorrect. Failure to correct material weaknesses in internal accounting control may represent a conscious decision by management to accept that degree of risk because of cost or other considerations. Choice "d" is incorrect. Disclosure of subsequent events is not indicative of an illegal act.

QUESTION 48
If specific information comes to an auditor's attention that implies the existence of possible illegal acts that could have a material, but indirect effect on the financial statements, the auditor should next:

A. Apply audit procedures specifically directed to ascertaining whether an illegal act 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 those charged with governance.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. If specific information comes to an auditor's attention that implies the existence of possible illegal acts that could have a material, but indirect effect on the financial statements, the auditor should next apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. The auditor should obtain an understanding of the situation, inquire of management (at a level above those involved), consult legal counsel, and consider applying additional audit procedures if necessary.
Choice "b" is incorrect. The auditor would consult with the client's legal counsel after obtaining an understanding of the situation and inquiring of management.
Choice "c" is incorrect. The auditor would inquire of management at a level above those involved after obtaining an understanding of the situation.
Choice "d" is incorrect. The auditor would only communicate with those charged with governance regarding detected illegal acts, not possible illegal acts.

QUESTION 49
When an auditor becomes aware of a possible illegal act by a client, the auditor should obtain an understanding of the nature of the act to:

A. Evaluate the effect on the financial statements.
B. Determine the reliability of management's representations.
C. Consider whether other similar acts may have occurred.
D. Recommend remedial actions to those charged with governance.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. When an auditor becomes aware of a possible client illegal act, the auditor should next obtain an understanding of the nature of the act in order to evaluate the effect on the financial statements.
Choices "b", "c", and "d" are incorrect. After evaluating the effect of the illegal act on the financial statements, the auditor may also determine the reliability of management's representations, consider whether other similar acts may have occurred, or recommend remedial actions to those charged with governance.

QUESTION 50
The auditor should obtain sufficient knowledge of the client's information and communication system relevant to financial reporting to understand all of the

following, except:

A. Classes of transactions in the entity's operations that are significant to the financial statements, and how those transactions are processed, from initiation to inclusion in the financial statements.
B. The financial reporting process, including development of significant accounting estimates and inclusion of appropriate disclosures.
C. The means the entity uses to communicate roles, responsibilities, and significant matters relating to financial reporting.
D. Control activities related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Ordinarily, audit planning does not require an understanding of the control activities related to each account balance, transaction class, and disclosure component in the FS or to every assertion relevant to them. Choice "a" is incorrect. The auditor is required to understand significant classes of transactions and how they are processed.
Choice "b" is incorrect. The auditor is required to understand the financial reporting process.
Choice "c" is incorrect. The auditor is required to understand the methods used by the entity to communicate matters relevant to financial reporting.

QUESTION 51
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.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Information that may raise a question-concerning possible illegal acts include unusually large payments made to:
- Cash
- Bearer
- Purchase cashiers checks
- Transfer funds to numbered accounts

Choice "a" is incorrect. Related party transactions may provide an indication of fraud, particularly if not made in the ordinary course of business, but they are generally not indicative of illegal acts.
Choice "c" is incorrect. Failure to correct material internal control weaknesses may represent a conscious decision by management to accept that degree of risk because of cost or other considerations. Choice "d" is incorrect. Contributions to local political candidates are legal and generally would not raise a question-about possible illegal acts.

QUESTION 52
Which of the following is not a control environment factor?

A. Participation of those charged with governance.
B. Hiring and advancement policies.
C. Management's approach toward business risks.
D. Proper segregation of duties.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Policies and procedures involving segregation of duties are control activities, not control environment factors.
Choice "a" is incorrect. Participation of those charged with governance is a control environment factor. Choice "b" is incorrect. Hiring and advancement policies are part of human resource policies and practices, which are control environment factors.
Choice "c" is incorrect. Management's approach toward business risks is part of its philosophy and operating style, which is a control environment factor.

QUESTION 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. Audit 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.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. When an auditor cannot rely on management's representations, he or she should withdraw from the engagement.
Choice "a" is incorrect. As long as the client takes appropriate remedial action, the auditor would not need to withdraw from the engagement simply because the client receives federal financial assistance.
However, the auditor would be subject to a variety of reporting requirements related to this discovery.
Choice "b" is incorrect. If there is no evidence that an illegal act was committed, management may be unable to take remedial action against the related employees. As long as the illegal act is immaterial and the auditor is satisfied that management's response is appropriate in the circumstances, there would be no reason for the auditor to withdraw.
Choice "d" is incorrect. The auditor should evaluate the adequacy of disclosure in the financial statements with respect to the potential effects of an illegal act. If the auditor concludes that disclosure is inadequate, he or she should express a qualified or adverse opinion, but would not necessarily need to withdraw from the engagement (unless the client refused to accept the modified report).

QUESTION 54
Which of the following statements is true regarding the risk assessment component of internal control?

A. An auditor evaluates an entity's risk assessment because it is a component of overall audit risk in a financial statement audit.
B. An auditor's evaluation of an entity's risk assessment may not be applicable to the audit of every entity.
C. An auditor evaluates an entity's risk assessment to understand how management addresses risks relevant to financial reporting.
D. An auditor need not consider an entity's risk assessment because he or she is primarily concerned with audit risk in a financial statement audit.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The auditor needs to understand how management addresses risks relevant to financial reporting in order to properly plan the audit. Choice "a" is incorrect. An entity's risk assessment differs from an auditor's assessment of audit risk.
The entity is concerned with managing risks that affect entity objectives (financial reporting, operations, and compliance) whereas the auditor is concerned with the risk that material misstatements could occur in the financial statements. Choice "b" is incorrect. The five components of internal control are applicable to the

audit of every entity.
Choice "d" is incorrect. The auditor needs to understand how management addresses risks relevant to financial reporting in order to properly plan the audit.

QUESTION 55
Before applying principal substantive tests to the details of accounts at an interim date prior to the balance sheet date, an auditor should:

A. Assess control risk at a low level for the assertions embodied in the accounts selected for interim testing.
B. Determine that the accounts selected for interim testing are not material to the financial statements taken as a whole.
C. Consider whether the amounts of the year-end balances selected for interim testing are reasonably predictable.
D. Obtain written representations from management that all financial records and related data will be made available.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Before performing substantive tests at an interim date, an auditor should consider whether the amounts of the year-end balances selected for interim testing are reasonably predictable with respect to amount, relative significance and composition.
Choice "a" is incorrect. It is not necessary for control risk to be assessed at a low level level for the assertions relating to the accounts that will be substantively tested at an interim date. It may simply be more efficient to perform a substantive audit. As long as the balances tested at interim are reasonably predictable with respect to amount, relative significance and composition, the account may be tested at interim.
Choice "b" is incorrect. Material account balances, such as accounts receivable and inventory, are commonly tested at an interim date. Choice "d" is incorrect. The written representation letter will not be obtained until after year-end.

QUESTION 56
Which of the following is not true with respect to the control activities of an entity?

A. Control activities are the policies and procedures that help ensure that management directives are carried out.
B. Control activities are the policies and procedures that help ensure that the financial statements are fairly presented in conformity with generally accepted accounting principles.
C. An understanding of control activities may be obtained while the auditor is obtaining an understanding of the other components of internal control.
D. An understanding of control activities does not require an understanding of control activities related to each account balance included in the financial statements.

Correct Answer: B
Section: Volume C

Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Control activities are the policies and procedures that help ensure that management directives are carried out. These policies and procedures may relate to any of the three objectives (financial reporting, operations, and compliance), not strictly to the financial reporting objective.
Choice "a" is incorrect. Control activities are defined as the policies and procedures that help ensure that management directives are carried out.
Choice "c" is incorrect. As an auditor obtains an understanding about the other components of internal control, he or she is also likely to obtain some knowledge about control activities. Choice "d" is incorrect. Ordinarily, audit planning does not require an understanding of control activities related to each account balance, transaction class, and disclosure component.

QUESTION 57
Before applying substantive tests to the details of asset accounts at an interim date, an auditor should assess:

A. Control risk at a low level.
B. Inherent risk at a high level.
C. The difficulty in controlling the incremental audit risk.
D. Materiality for the accounts tested as insignificant.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Before performing substantive tests at an interim date, the auditor must assess the difficulty in controlling the incremental audit risk from the interim date (on which the substantive procedures are performed) to the yearend date (on which an opinion is rendered).
Choice "a" is incorrect. The auditor would not have to assess control risk at a low level in order to perform substantive tests at interim. It may simply be more efficient to perform a substantive audit. As long as the balances tested at interim are reasonably predictable with respect to amount, relative significance and composition, the account may be tested at interim.
Choice "b" is incorrect. Generally, inherent risk should be low in order to test substantively at interim.
Choice "d" is incorrect. If the materiality level for those accounts to be tested is insignificant, then the auditor probably would not perform any substantive testing, since it is unlikely that a material error exists in an insignificant balance.

QUESTION 58
Which of the following statements best describes how a detailed audit plan of a CPA who is engaged to audit the financial statements of a large publicly held

company compares with the audit client's comprehensive internal audit program?

A. The comprehensive internal audit plan is substantially identical to the audit plan used by the CPA because both cover substantially identical areas.
B. The comprehensive internal audit plan is less detailed and covers fewer areas than would normally be covered by the CPA.
C. The comprehensive internal audit plan is more detailed and covers areas that would normally not be covered by the CPA.
D. The comprehensive internal audit plan is more detailed although it covers fewer areas than would normally be covered by the CPA.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. "Internal auditors" are part of the system of internal control. Their audits would cover more areas in greater depth than those of the "independent auditors," whose concerns are limited to areas materially affecting the "financial statements taken as a whole."
Choices "a", "b", and "d" are incorrect, as described above.

QUESTION 59
When assessing an internal auditor's objectivity, an independent auditor should:

A. Evaluate the adequacy of the internal auditor's audit plans.
B. Inquire about the internal auditor's educational background and professional certification.
C. Consider the organizational level to which the internal auditor reports.
D. Review the internal auditor's audit documentation.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. When assessing an internal auditor's objectivity, an independent auditor should consider the organizational level to which the internal auditor reports.
Choice "a" is incorrect. Evaluating the adequacy of the internal auditor's audit plans would be performed when assessing an internal auditor's competence.
Choice "b" is incorrect. Inquiring about the internal auditor's educational background and professional certification would be performed when assessing an

internal auditor's competence.
Choice "d" is incorrect. Reviewing the internal auditor's audit documentation (to determine the quality of the reports and recommendations) would be performed when assessing an internal auditor's competence.

QUESTION 60
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.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding disagreements the predecessor had with the client concerning auditing procedures and accounting principles.
Choice "b" is incorrect. The successor auditor may make specific inquiries of the predecessor auditor regarding the predecessor's evaluation of matters of continuing accounting significance, but this would occur after accepting the engagement.
Choice "c" is incorrect. The successor auditor may make specific inquiries of the predecessor auditor regarding the degree of cooperation the predecessor received concerning the inquiry of the client's lawyer, but this would occur after accepting the engagement.
Choice "d" is incorrect. The successor auditor would generally come to his or her own conclusions regarding assessments of inherent risk and judgments about materiality without consulting the predecessor auditor.

QUESTION 61
Ordinarily, the predecessor auditor permits the successor auditor to review the predecessor's audit documentation relating to:

	Contingencies	Balance sheet accounts
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Ordinarily, the predecessor auditor permits the successor auditor to review the predecessor's audit documentation relating to matters of continuing accounting and auditing significance, including both contingencies and balance sheet accounts. Contingencies have continuing significance as they may continue to affect the current year financial statements (either by remaining as contingencies or by being resolved); balance sheet accounts from the prior year-end have continuing significance since they are the opening balances for the current year. Choices "b", "c", and "d" are incorrect, per above explanation.

QUESTION 62
The understanding with a client of an auditor's contractual obligation ordinarily is set forth in the:

A. Management letter.
B. Scope paragraph of the auditor's report.
C. Engagement letter.
D. Introductory paragraph of the auditor's report.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. An engagement letter, which is a presumptively mandatory requirement, sets forth the scope and nature of an auditor's contractual obligation to a client.
Choice "a" is incorrect. A management letter (also known as a letter of recommendations, or a constructive services letter) is usually delivered by the auditor at the end of the audit. It identifies areas of weakness and provides recommended solutions.

Choices "b" and "d" are incorrect. The scope and introductory paragraphs of the auditor's report do provide some information regarding the work performed by the auditor, but they do not express the auditor's understanding with the client as completely as does an engagement letter.

QUESTION 63
An auditor should obtain knowledge of a client's information and communication system in order to understand each of the following, except:

A. How transactions are initiated, processed, and reported.
B. The process used to prepare financial statements.
C. The means used by an entity to communicate financial reporting roles to its staff.
D. The means used by an entity to ensure that management directives are carried out.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Control activities (not the information and communication system) are the policies and procedures that help ensure that management directives are carried out.
Choices "a", "b", and "c" are incorrect. The auditor obtains an understanding of an entity's information and communication system to understand how transactions are initiated, processed, and reported, the financial reporting process, and the means used by an entity to communicate financial reporting roles and responsibilities.

QUESTION 64
The monitoring component of internal control excludes:

A. Assessing information derived from external parties.
B. Assessing the quality of internal control performance over time.
C. Improving controls that are not operating effectively.
D. Eliminating controls that are not operating effectively.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Monitoring is the process of assessing the quality of internal control performance over time and taking necessary corrective actions. Eliminating a control that is not operating effectively would not be an appropriate corrective action.
Choice "a" is incorrect. Information derived from external parties (such as customer complaints and regulator comments) may be useful in identifying problems with the internal control structure. Choices "b" and "c" are incorrect. Assessing the quality of internal control performance over time and improving controls that are not operating effectively are part of the monitoring process.

QUESTION 65
In planning an audit of a new client, an auditor most likely would consider the methods used to process accounting information because such methods:

A. Influence the design of internal control.
B. Affect the auditor's preliminary judgment about materiality levels.
C. Assist in evaluating the planned audit objectives.
D. Determine the auditor's acceptable level of audit risk.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The auditor would consider the methods used to process accounting information in planning an audit of a new client, because such methods influence the design of internal control. The auditor is required to obtain an understanding of the design of internal control in order to plan the audit and determine the nature, timing, and extent of tests to be performed.
Choice "b" is incorrect. The auditor's judgment about materiality levels is based upon the auditor's perception of the needs of a reasonable person who will rely on the financial statements, not on the methods used to process accounting information.
Choice "c" is incorrect. The planned audit objectives are based upon the auditor's desire to render an opinion on the fairness of the financial statements. This end goal is not influenced by the methods used by the client to process accounting information.
Choice "d" is incorrect. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. The auditor's only acceptable level of audit risk is low, and this is not affected by the client's methods used to process accounting information.

QUESTION 66
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 placed in operation 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 (an):

A. Description of the scope and nature of Price's procedures.

B. Statement that Dunn may assess control risk based on Price's report.
C. Assertion that Price assumes no responsibility to determine whether QSC's controls are suitably designed.
D. Opinion on the operating effectiveness of QSC's internal controls.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Price, CPA (the "service auditor") should include in his or her report a description of the scope and nature of the procedures performed.
Choices "b" and "d" are incorrect. A report on controls placed in operation does not provide an opinion on operating effectiveness, and therefore may not be used to assess control risk.
Choice "c" is incorrect. A report on controls placed in operation includes a statement that, "our examination included procedures to obtain reasonable assurance about whether the controls were suitably designed."

QUESTION 67
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 placed in operation 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:

A. Contain a disclaimer of opinion on the operating effectiveness of PDC's controls.
B. State whether PDC's controls were suitably designed to achieve the retailer's objectives.
C. Identify PDC's controls relevant to specific financial statement assertions.
D. Disclose Cook's assessed level of control risk for PDC.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. There are two types of reports on the processing of transactions by service organizations: "reports on controls placed in operation" and "reports on controls placed in operation and tests of operating effectiveness." The former do not include tests of operating effectiveness and, therefore, are not intended to provide the user auditor with a basis for reducing the assessment of control risk. Accordingly, such reports should include a disclaimer of opinion

regarding the operating effectiveness of the controls.
Choice "b" is incorrect. The report should contain an indication that the controls were suitably designed to achieve specified control objectives, but it does not provide any assurance regarding the achievement of the user organization's (in this case, the retailer's) objectives.
Choice "c" is incorrect. The service auditor (Cook) is not required to identify the service organization's (i.e., PDC's) controls relevant to specific financial statement assertions because this is not a financial statement audit. Choice "d" is incorrect. The service auditor (Cook) is not required to disclose the assessed level of control risk for the service organization (PDC).

QUESTION 68
Computer Services Company (CSC) processes payroll transactions for schools. Drake, CPA, is engaged to report on CSC's internal controls placed in operation as of a specific date. These internal controls 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 internal controls placed in operation as of a specific date should contain a(an):

A. Description of the scope and nature of Drake's procedures.
B. Statement that CSC's management has disclosed to Drake all design deficiencies of which it is aware.
C. Opinion on the operating effectiveness of CSC's internal controls.
D. Paragraph indicating the basis for Drake's assessment of control risk.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. A report on internal controls for a service organization should include a description of the scope and nature of Drake's procedures.
Choice "b" is incorrect. No statement is made in the report that all design deficiencies have been disclosed. Choice "c" is incorrect. The service auditor's opinion is not intended to provide evidence of operating effectiveness. Choice "d" is incorrect. No paragraph indicating the basis for the assessment of control risk is included in Drake's report.

QUESTION 69
A successor auditor should request the new client to authorize the predecessor auditor to allow a review of the predecessor's:

	Engagement letter	Audit Documentation
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. It is not appropriate for the successor auditor to request a review of the predecessor auditor's engagement letter. This is a business matter between the client and the predecessor auditor that has no impact on the successor's audit. Conversely, review of the predecessor auditor's audit documentation is appropriate and customary to facilitate the successor's audit. Choices "a", "b", and "d" are incorrect, based on the above explanation.

QUESTION 70
When an auditor increases the planned 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 details.
B. Level of inherent risk.
C. Extent of tests of controls.
D. Level of detection risk.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. When an auditor increases the planned assessed level of control risk because certain control activities were determined to be ineffective, detection risk must be reduced accordingly. This may be accomplished by increasing the extent of tests of details.
Choice "b" is incorrect. The level of inherent risk is not directly related to the planned level of control risk.
Choice "c" is incorrect. The auditor performs tests of controls to evaluate the operating effectiveness of those controls. Once they have been determined to be ineffective, there would be no reason to perform further tests of those controls. Choice "d" is incorrect. The level of detection risk that the auditor could accept would decrease if the planned level of control risk increased.

QUESTION 71
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 structure. Lake is considering Cope's report on EDP's internal control structure 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?

A. Lake may refer to Cope only if Lake is satisfied as to Cope's professional reputation and independence.
B. Lake may refer to Cope only if Lake relies on Cope's report in restricting the extent of substantive tests.
C. Lake may refer to Cope only if Lake's report indicates the division of responsibility.
D. Lake may not refer to Cope under the circumstances above.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The user auditor should not make reference to the report of the service auditor as a basis, in part, for his or her own opinion on the user organization's financial statements. Since the service auditor is not responsible for the examination of any part of the user organization's financial statements, division of responsibility would be inappropriate. Choices "a", "b", and "c" are incorrect, based on the above explanation.

QUESTION 72
Which of the following items does not pertain to the control environment?

A. Management's philosophy and operating style.
B. Participation of those charged with governance.

C. The accounting records.
D. Personnel policies and practices.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The accounting records pertain to the information and communication system, not to the control environment.
Choices "a", "b", and "d" are incorrect, as management's philosophy and operating style, participation of those charged with governance, and personnel policies and practices are all part of the control environment.

QUESTION 73
On receiving a client's bank cutoff statement, an auditor most likely would trace:

A. Prior-year checks listed in the cutoff statement to the year-end outstanding checklist.
B. Deposits in transit listed in the cutoff statement to the year-end bank reconciliation.
C. Checks dated after year-end listed in the cutoff statement to the year-end outstanding checklist.
D. Deposits recorded in the cash receipts journal after year-end to the cutoff statement.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The auditor should obtain bank cutoff statements that include transactions for 10 to 15 days after year-end. The outstanding checks and deposits in transit at year-end on the bank reconciliation should agree with the information in the bank cutoff statement.
Choice "b" is incorrect. The deposits in transit are listed in the year-end bank reconciliation and traced to actual deposits appearing on the bank cutoff statement. The cutoff statement includes actual deposits received, not deposits in transit.
Choice "c" is incorrect. Checks dated after year-end would not be included in the year-end outstanding checklist.
Choice "d" is incorrect. Deposits recorded in the cash receipts journal after year-end do not affect the cash balance at year-end, and therefore the auditor would not perform audit procedures with respect to those deposits.

QUESTION 74
Which of the following characteristics most likely would be indicative of check kiting?

A. High turnover of employees who have access to cash.
B. Many large checks that are recorded on Mondays.
C. Low average balance compared to high level of deposits.
D. Frequent ATM checking account withdrawals.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Kiting occurs when a check drawn on one bank is deposited in another bank and no record is made of the disbursement in the balance of the first bank. Frequent kiting may result in a high level of deposits coupled with a low average balance.
Choice "a" is incorrect. High turnover of employees who have access to cash may be normal in certain industries, or it may be indicative of poor hiring policies, but it would not be indicative of check kiting.
Choice "b" is incorrect. More checks may arrive on Mondays simply because Monday's mail includes the mail from over the weekend. This characteristic is not particularly indicative of check kiting. Choice "d" is incorrect. Frequent ATM checking account withdrawals indicate a frequent need for cash, but this situation is not particularly indicative of check kiting.

QUESTION 75
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 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.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The function of cash receipts is part of the treasurer's department and should be separate from the role of posting credits to the A/R ledger. Failure to separate the recordkeeping function from the custodial function allows an individual to misappropriate cash and then cover up the theft by posting credits against the related A/R balance.
Choice "a" is incorrect. If fictitious transactions in the revenue cycle are recorded, then the impact on revenues and receivables would be the same; either both would be overstated (the most likely case) or both would be understated. Choice "b" is incorrect. Even the lack of effective internal controls would not allow this fraud to be perpetrated for long, since the customers that submitted the claim would complain that the credit was not properly applied as soon as they received their next statement or invoice.
Choice "d" is incorrect. The failure to prepare shipping documents may cause inventory to be overstated, but it is unlikely to be perpetrated as a fraud since it does not allow theft of cash. In addition, the internal controls in the revenue cycle typically relate to sales, receivables, and cash, not to inventory.

QUESTION 76
Which of the following internal 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.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. A lockbox system is the best means of preventing defalcation of cash by employees because the employees never have direct access to cash receipts.
Choice "b" is incorrect. The use of prenumbered remittance advices is not effective in preventing theft of receipts by employees because it does not prevent employee access to cash receipts.
Choice "c" is incorrect. While the performance of monthly bank reconciliations is a good control, it would not be effective in preventing the theft of receipts because it does not prevent employee access to cash receipts. (It might, however, be effective at detecting a theft that has already occurred).
Choice "d" is incorrect. Daily deposit of cash receipts is not an effective control for preventing theft of receipts by employees because it does not prevent employee access to cash receipts.

QUESTION 77
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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Once signed, the check should be mailed to the payee by the check signer or an employee operating under the supervision of the check signer to prevent defalcations of checks. Generally this occurs in the treasurer's department.
Choice "a" is incorrect. The check signer would not normally review bank reconciliations.
Choice "b" is incorrect. Accounts payable personnel should not have custody of signed checks since this would constitute a lack of segregation of duties between recording and custody. Choice "c" is incorrect. The check signer should have access to supporting documentation so that it can be reviewed before the check is signed.

QUESTION 78
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.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. The standard AICPA bank confirmation form includes spaces for the bank to confirm both cash balances on deposit at the bank and collateral pledged on loans originating from the bank.
Choice "a" is incorrect. Purchase commitments are not typically confirmed on an accounts payable confirmation request.
Choice "c" is incorrect. Contingent liabilities (confirmed in a letter of inquiry to the client's attorney or bank) and inventory on consignment (confirmed with the

consignee) are not confirmed together. Choice "d" is incorrect. Accrued interest receivable (usually on investments held by a trust company) is not typically confirmed along with trade accounts receivable.

QUESTION 79
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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. A bank employee may not have access to all information about transactions with the audit client and thus may be unaware of all the financial relationships the bank has with the client.
Choice "a" is incorrect. Standard bank confirmations contain a signature from an authorized client employee and are a very commonly used audit procedure. It is unlikely that a bank would refuse the request since it has been authorized by the client.
Choice "b" is incorrect. The confirmation is used to verify the bank balance as of year-end. Bank employees generally would not have access to the client's bank reconciliation.
Choice "c" is incorrect. Even though it is likely that the bank would have access to a cutoff bank statement, the detail on this statement is unnecessary to confirm the final balance.

QUESTION 80
Which of the following procedures would an auditor most likely perform in searching for unrecorded liabilities?

A. Vouch 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.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The auditor is able to detect liabilities not recorded at year-end by comparing cash payments made after the balance sheet date to the related receiving reports and vendor invoices; any payments made on transactions dated before year-end reflect a liability that should have been recorded.
Choice "a" is incorrect. Vouching a sample of recorded accounts payable entries to unmatched receiving reports does not test the completeness of the listing. Unrecorded liabilities would not be included in recorded accounts payable entries.
Choice "b" is incorrect. Purchase orders issued after year-end should not be included in the year-end balance of accounts payable. This would be an example of an overstated liability, rather than an unrecorded one.
Choice "d" is incorrect. Examination of cash disbursements entries made just prior to the balance sheet date relates to liabilities that have been paid, which would not be considered to be outstanding liabilities at year-end.

QUESTION 81
An auditor traced a sample of purchase orders and the related receiving reports to the purchases journal and the cash disbursements journal. The purpose of this substantive audit procedure most likely was to:

A. Identify unusually large purchases that should be investigated further.
B. Verify that cash disbursements were for goods actually received.
C. Determine that purchases were properly recorded.
D. Test whether payments were for goods actually ordered.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. In general, an audit procedure can be restated as the question-to be answered. In this case, tracing a sample of purchase orders and related receiving reports to the purchases journal and the cash disbursements journal seeks to answer the question, "Were all purchases properly recorded?" (the completeness assertion).
Choice "a" is incorrect. Tracing a sample of source documents to summary records would not identify unusually large transactions requiring additional attention.
Choice "b" is incorrect. In order to verify that cash disbursements were for goods actually received, a sample of cash disbursements should be vouched back to receiving reports. Choice "d" is incorrect. In order to verify that cash disbursements were for goods actually ordered, a sample of cash disbursements should be vouched back to purchase orders.

QUESTION 82

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.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Upon receipt of cash, a remittance listing should be prepared.
Choice "a" is incorrect. Recording the check in the daily cash summary would ordinarily be done by a second party after the initial listing has been prepared.
Choice "b" is incorrect. Verifying that each check is supported by a valid invoice is not necessary.
Choice "d" is incorrect. Recording the check in the cash receipts journal would ordinarily be done by a second party after the initial listing has been prepared.

QUESTION 83
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.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. By stamping the voucher "paid," the check signer cancels the voucher so it cannot be resubmitted for payment.
Choice "a" is incorrect. Even invoices that are supported by prenumbered sales invoices can be resubmitted for payment if they are not canceled, resulting in

duplicate payments.
Choice "c" is incorrect. Accounting for the sequence of prenumbered vouchers would only test whether all vouchers are present. It would not prevent a voucher from being paid twice. Choice "d" is incorrect. Proper authorization would help ensure that payments were properly authorized, but would not prevent duplicate payments.

QUESTION 84
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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. The treasurer does not perform duties that are incompatible with authorizing writeoffs since he or she is usually not involved with sales transactions or recordkeeping.
Choice "a" is incorrect. Recording accounts receivable and authorizing write-offs would constitute an improper segregation of duties.
Choice "b" is incorrect. Granting credit and authorizing write-offs represents an improper segregation of duties since non-existent customers could have credit authorized and then have their accounts written off. Choice "c" is incorrect. The accounts payable department is typically involved in the expenditure cycle, not the revenue cycle.

QUESTION 85
Which of the following procedures most likely would not be an internal control designed to reduce the risk of errors 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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Reconciling control totals for sales invoices with the accounts receivable subsidiary ledger is not an effective control related to the billing process, since errors that exist in the preparation of invoices would likely carry through to accounts receivable.
Choice "a" is incorrect. Comparing shipping totals with sales invoice totals is an effective control to reduce billing errors.
Choice "b" is incorrect. Computer controls related to pricing and mathematical accuracy will reduce billing errors.
Choice "c" is incorrect. Matching shipping documents with approved sales orders ensures that invoices are properly authorized and only goods ordered have been shipped.

QUESTION 86
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. Occurrence.
C. Accuracy.
D. Rights and obligations.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Vouching to supporting documents tests the occurrence assertion.
Choice "a" is incorrect. Tracing from supporting documentation to the voucher register would support the completeness assertion.
Choice "c" is incorrect. The accuracy assertion would be tested by examining the details of the supporting documents. Choice "d" is incorrect. The rights and obligations assertion does not relate to transactions and events.

QUESTION 87
Which of the following internal control activities 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.

Correct Answer: D
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "d" is correct. Accounting for unused prenumbered purchase orders and receiving reports is an effective control, but it would not typically be performed in the vouchers payable department. Choice "a" is incorrect. Reconciling the vendor invoice with the related receiving report is typically performed by a vouchers payable clerk.
Choice "b" is incorrect. The vouchers payable department is responsible for approving vouchers for payment.
Choice "c" is incorrect. Indicating the asset and expense accounts to be debited is not an internal control procedure.

QUESTION 88
Which of the following tests of controls most likely would help assure an auditor that goods shipped are properly billed?

A. Scan the sales journal for sequential and unusual entries.
B. Examine shipping documents for matching sales invoices.
C. Compare the accounts receivable ledger to daily sales summaries.
D. Inspect unused sales invoices for consecutive prenumbering.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Tracing from a sample of shipping documents to matching sales invoices would provide support for the completeness assertion for billing.
Choice "a" is incorrect. Scanning the sales journal for sequential and unusual entries tests the completeness and existence assertions for sales, but would not provide assurance that shipped goods were properly billed.
Choice "c" is incorrect. Comparing the accounts receivable ledger to the daily sales summary helps ensure that all sales were recorded as receivables and all receivables were recorded as sales, but it does not provide assurance that shipped goods were properly billed.
Choice "d" is incorrect. Inspecting the consecutive numbering of unused sales invoices might identify fictitious sales, but it would not ensure that goods that have

been shipped were properly billed.

QUESTION 89
An auditor's purpose in reviewing credit ratings of customers with delinquent accounts receivable most likely is to obtain evidence concerning management's assertions about:

A. Valuation and allocation.
B. Understandability and classification.
C. Existence.
D. Rights and obligations.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Assertions about valuation and allocation deal with whether asset, liability, revenue, and expense components have been included in the financial statements at appropriate amounts, and any resulting valuation adjustments are appropriately recorded. For example, management asserts that trade accounts receivable included in the balance sheet are stated at net realizable value.
Choice "b" is incorrect. Assertions about understandability and classification deal with whether financial information is appropriately presented and described, and disclosures are clearly expressed. Reviewing credit ratings of delinquent customers does not provide evidence about this type of assertion.
Choice "c" is incorrect. Assertions about existence deal with whether assets, liabilities, and equity interest of the entity exist at a given date. Reviewing credit ratings of delinquent customers does not provide evidence about this type of assertion.
Choice "d" is incorrect. Assertions about 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. Reviewing credit ratings of delinquent customers does not provide evidence about this type of assertion.

QUESTION 90
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.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Examination of reports of shipments not recorded in the sales journal is an appropriate test of controls to determine whether all sales have been recorded.
Choice "a" is incorrect. Verification that extensions and footings on sales invoices and statements have been recomputed by client personnel ensures that independent checks are being performed, but does not address whether all sales transactions have been recorded.
Choice "c" is incorrect. Comparison of invoiced prices with the client's authorized price list ensures that the prices charged are authorized, but does not address whether all sales transactions have been recorded. Choice "d" is incorrect. Inquiring about credit policies is an appropriate audit procedure to verify authorization and valuation of sales transactions, not completeness.

QUESTION 91
Which of the following internal 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.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. Comparison of daily sales summaries to daily postings to the accounts receivable ledger would ensure the completeness of the accounts receivable ledger.
Choice "b" is incorrect. Comparison of sales invoices to shipping documents verifies occurrence of the sale, not completeness of the accounts receivable ledger.
Choice "c" is incorrect. Reconciliation of the accounts receivable ledger to the general ledger would not assure the accuracy and completeness of the accounts receivable ledger because a sale which was improperly excluded from receivables would likely be omitted from both ledgers.
Choice "d" is incorrect. Ensuring that all shipments are billed verifies completeness of sales transactions, but does not provide evidence that all sales are recorded in the accounts receivable ledger. In other words, the fact that a shipment was billed does not mean that the invoice was also recorded in the accounts receivable ledger.

QUESTION 92
Under 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.

Correct Answer: B
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "b" is correct. Matching vendor's invoices with receiving reports provides authorization for payment and is generally performed in the accounts payable department. Recalculation of vendor invoices is compatible with this authorization function.
Choice "a" is incorrect. Posting the accounts payable records (recording) is incompatible with matching (authorization). Generally these functions would be performed by two different employees.
Choice "c" is incorrect. This review procedure (independent verification) should be performed by someone independent of the employee who approved the invoice for payment. Choice "d" is incorrect. Payment and cancellation of vendor invoices should be performed by someone (generally the treasurer) other than the individual authorizing payment.

QUESTION 93
To determine whether internal control relative to the revenue cycle of a wholesaling entity is operating effectively in minimizing the failure to prepare sales invoices, an auditor most likely would select a sample of transactions from the population represented by the:

A. Sales order file.
B. Customer order file.
C. Shipping document file.
D. Sales invoice file.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:

Section: Volume C

Choice "c" is correct. Shipping documents provide evidence that a sale occurred, and therefore selecting from a population of shipping documents allows the auditor to test whether corresponding invoices exist for each sale. Choices "a" and "b" are incorrect. The existence of customer orders and sales orders does not necessarily imply that a sale occurred. For example, the particular item requested may be out of stock.
In such cases, there would properly be no sales invoice.
Choice "d" is incorrect. Since the weakness the auditor is concerned about involves missing sales invoices, selecting from a sample of existing sales invoices would not identify this problem.

QUESTION 94
Which of the following events occurring in the year under audit would most likely indicate that internal controls utilized in previous years may be inadequate in the year under audit?

A. The entity announced that the internal audit function would be eliminated after the balance sheet date.
B. The audit committee chairperson unexpectedly resigned during the year under audit.
C. The chief financial officer waived approvals on all checks to one vendor to expedite payment.
D. The frequency of accounts payable check runs was changed from biweekly to weekly.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Vouchers should be approved before payment occurs. Overriding this control to expedite payment may result in unauthorized payments being made. The auditor would need to consider this change in evaluating current controls and determining the nature, timing, and extent of testing.
Choice "a" is incorrect. If the internal audit function is being eliminated after the balance sheet date, there would be little effect on the current year's audit.
Choice "b" is incorrect. Resignation of the audit committee chairperson would not imply that internal controls are less adequate than in the past, as long as a new, competent person steps up to become chair.
Choice "d" is incorrect. Changing the frequency of the accounts payable check runs from biweekly to weekly would not automatically imply that controls are inadequate. The auditor would need to review the new procedures to determine whether adequate controls were still in place.

QUESTION 95
An auditor who uses a transaction cycle approach to assessing control risk most likely would test control activities related to transactions involving the sale of goods to customers with the:

A. Collection of receivables.

B. Purchase of merchandise inventory.
C. Payment of accounts payable.
D. Sale of long-term debt.

Correct Answer: A
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "a" is correct. The revenue cycle includes sales, receivables, and cash receipts, so an auditor using a transaction cycle approach would be likely to test sales and receivables together.
Choice "b" is incorrect. Purchases are part of the expenditures cycle while sales are part of the revenue cycle, so an auditor using a transaction cycle approach would be unlikely to test these items together.
Choice "c" is incorrect. Payables are part of the expenditures cycle while sales are part of the revenue cycle, so an auditor using a transaction cycle approach would be unlikely to test these items together.
Choice "d" is incorrect. Sale of long-term debt falls within the "other liabilities" transaction cycle while sales are part of the revenue cycle, so an auditor using a transaction cycle approach would be unlikely to test these items together.

QUESTION 96
Tracing copies of computer-prepared sales invoices to copies of the corresponding computer-prepared shipping documents provides evidence that:

A. Shipments to customers were properly billed.
B. Entries in the accounts receivable subsidiary ledger were for sales actually shipped.
C. Sales billed to customers were actually shipped.
D. No duplicate shipments to customers were made.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. Tracing from invoices to shipping documents would provide evidence that sales billed to customers were actually shipped. An invoice for which the corresponding shipping documents could not be located might be indicative of fictitious sales (i.e., sales that were recorded but never actually

shipped).
Choice "a" is incorrect. The auditor would need to start with shipping documents and trace to invoices to ensure that shipments were properly billed.
Choice "b" is incorrect. An invoice may exist for which no entry was made in the accounts receivable subsidiary ledger. Therefore, the auditor would need to trace from entries in the accounts receivable subsidiary ledger (and not from invoices) to shipping documents, to obtain evidence that recorded receivables were for sales actually shipped.
Choice "d" is incorrect. Tracing from invoices to shipping documents would not necessarily indicate when a duplicate shipment was made, as the auditor would not necessarily realize that two sets of shipping documents related to the same invoice.

QUESTION 97
Which of the following fraudulent activities most likely could be perpetrated due to the lack of effective internal controls in the revenue cycle?

A. Merchandise received is not promptly reconciled to the outstanding purchase order file.
B. Obsolete items included in inventory balances are rarely reduced to the lower of cost or market value.
C. The write-off of receivables by personnel who receive cash permits the misappropriation of cash.
D. Fictitious transactions are recorded that cause an understatement of revenue and overstatement of receivables.

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. The function of cash receipts is part of the treasurer's department and should be separate from the role of writing off receivables. Failure to separate the recordkeeping function from the custodial function allows an individual to misappropriate cash and then cover up the theft by writing off the related receivable balance.
Choice "a" is incorrect. Internal controls in the revenue cycle typically relate to sales, receivables, and cash, not to the purchase and receipt of goods.
Choice "b" is incorrect. Internal controls in the revenue cycle typically relate to sales, receivables, and cash, not to inventory valuation.
Choice "d" is incorrect. If fictitious transactions in the revenue cycle are recorded, then the impact on revenues and receivables would be the same; either both would be overstated (the most likely case) or both would be understated.

QUESTION 98
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 assertions of:

	Understandability and classification	Existence
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume C
Explanation

Explanation/Reference:
Section: Volume C

Choice "c" is correct. In testing the existence or occurrence assertion, the auditor is concerned that fictitious or overstated receivables may have been recorded. Observing the mailing of monthly statements and reviewing evidence of followup on errors reported by customers provides evidence that procedures are in place to identify and correct such errors.
Choice "a" is incorrect. Follow up of errors in monthly statements does not provide any evidence to support understandability and classification.
Choice "b" is incorrect. Follow up of errors in monthly statements does not provide any evidence to support understandability and classification, but does provide evidence regarding the existence of receivables. Choice "d" is incorrect. Follow up of errors in monthly statements does provide evidence regarding the existence of receivables, since customers will be likely to report discrepancies.

QUESTION 99
Which of the following cash transfers results in a misstatement of cash at December 31, 20X1?

Bank Transfer Schedule

Transfers	Disbursement date per books	Disbursement date per bank	Receipt date per books	Receipt date per bank
A.	12/31/X1	01/05/X2	12/31/X1	01/04/X2
B.	01/04/X2	01/11/X2	01/04/X2	01/04/X2
C.	12/31/X1	01/04/X2	12/31/X1	12/31/X1
D.	01/04/X2	01/05/X2	12/31/X1	01/04/X2

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Since the disbursement was not recorded until January 20X2 while the receipt was recorded in December 20X1, cash will be overstated at December 31, 20X1.
Choices "a" and "c" are incorrect. Both the disbursement and the receipt are recorded in 20X1, so there will be no misstatement of cash at December 31, 20X1.
Choice "b" is incorrect. Both the disbursement and the receipt are recorded in 20X2, so there will be no misstatement of cash at December 31, 20X1.

QUESTION 100
After making inquiries about credit granting policies, an auditor selects a sample of sales transactions and examines evidence of credit approval. This test of controls most likely supports management's financial statement assertion(s) of:

	Rights and obligations	Allocation and valuation
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. By ensuring that credit approval is obtained before goods are shipped to customers, the auditor is testing management's assertion that accounts receivable are collectible (allocation and valuation). Ensuring that credit approval is obtained before goods are shipped does not support the rights and obligations assertion. Choices "a", "b", and "d" are incorrect, based on the above .

QUESTION 101
Which of the following would not be considered a significant audit finding that should be included in audit documentation?

A. Retirement of the accounts payable manager and subsequent hiring of a replacement.
B. Discovery of a material sale recorded in the current year that properly belonged in the subsequent year.
C. Determination that there is substantial doubt about the entity's ability to continue as a going concern.
D. Implementation of a new accounting standard to account for a complex and unusual transaction.

Correct Answer: A
Section: Volume D

Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Significant audit findings do not include staffing changes at the client.
Choice "b" is incorrect. Discovery of a material sale recorded in the current year that properly belonged in the subsequent year represents a possible material misstatement in the financial statements. Possible material misstatements are considered to be significant audit findings.
Choice "c" is incorrect. When substantial doubt about an entity's ability to continue as a going concern exists, there is likely to be a modification to the auditor's standard report. Items resulting in report modifications are generally considered to be significant audit findings.
Choice "d" is incorrect. Matters related to the application of accounting principles to complex and unusual transactions are considered to be significant audit findings.

QUESTION 102
Which of the following is not true regarding audit documentation for a specific audit?

A. Audit documentation should be sufficient to enable members of the audit team with supervisory responsibilities to understand the nature, timing, extent, and results of auditing procedures performed.
B. Audit documentation should indicate which member(s) of the audit team performed and reviewed the audit work.
C. Audit documentation should demonstrate compliance with quality control standards.
D. Audit documentation should demonstrate compliance with the standards of fieldwork.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
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Choice "c" is correct. Quality control standards relate to the conduct of a firm's audit practice as a whole, and compliance with such standards would not be demonstrated by audit documentation for one specific audit engagement. Choice "a" is incorrect. Audit documentation should clearly indicate the work performed and the evidence obtained. Choice "b" is incorrect. Audit documentation should indicate which parties performed and reviewed the work.
Choice "d" is incorrect. Audit documentation should demonstrate compliance with the standards of fieldwork. It should indicate an appropriate level of planning and supervision, that a sufficient understanding of the entity and its environment, including its internal control, was obtained, and that a sufficient level of appropriate evidence was obtained.

QUESTION 103
The permanent (continuing) file of audit documentation most likely would include copies of the:

A. Lead schedules.
B. Attorney's letters.
C. Bank statements.
D. Debt agreements.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The permanent file includes items with continuing audit significance, such as debt agreements.
Choice "a" is incorrect. Lead schedules would be included in the current audit documentation since they are applicable to the current year's audit only.
Choice "b" is incorrect. Attorney's letters would be included in the current audit documentation since they are applicable to the current year's audit only.
Choice "c" is incorrect. Bank statements would be included in the current audit documentation since they are applicable to the current year's audit only.

QUESTION 104
Which of the following pairs of accounts would be analyzed together in the audit documentation?

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.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The auditor would most likely analyze notes receivable and its related income statement account, interest income, together.
Choice "b" is incorrect. Accrued interest payable would be analyzed along with notes payable; accrued interest receivable would be analyzed along with notes receivable.
Choice "c" is incorrect. Notes payable would be analyzed along with interest payable and interest expense; notes receivable would be analyzed along with

interest income. Choice "d" is incorrect. Interest income would be analyzed with notes receivable; interest expense would be analyzed with notes payable.

QUESTION 105
Audit documentation serves 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 activities.
D. Document the level of independence maintained by the auditor.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Audit documentation serves mainly to provide 1) the principal support for the auditor's report; 2) assistance in the planning, conduct, and supervision of the audit; 3) accountability; and 4) useful information. Choice "b" is incorrect. Audit documentation does not satisfy the auditor's responsibilities concerning the Code of Professional Conduct.
Choice "c" is incorrect. Audit documentation does not monitor the effectiveness of the CPA firm's quality control activities. Choice "d" is incorrect. Audit documentation does not document the level of independence maintained by the auditor.

QUESTION 106
The permanent file of the audit documentation for an engagement generally would not include:

A. Bond indenture agreements.
B. Lease agreements.
C. Working trial balance.
D. Flowchart of internal control.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. A working trial balance is a part of the current year's audit documentation.
Choice "a" is incorrect. Bond indenture agreements are typically found in the permanent file.
Choice "b" is incorrect. Lease agreements are typically found in the permanent file.
Choice "d" is incorrect. An internal control flowchart is typically found in the permanent file.

QUESTION 107
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 tickmarks.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The working trial balance generally contains a column for adjustments and reclassifications.
Choice "a" is incorrect. The working trial balance does not ordinarily contain information about cash flows.
Choice "b" is incorrect. Audit objectives and assertions are contained in the audit plan, which is generally kept separate from the working trial balance. Choice "d" is incorrect. Reconciliations and tickmarks are found in other parts of the audit documentation.

QUESTION 108
Which of the following factors would least likely affect the nature and extent of audit documentation?

A. The nature of the specific audit procedures.
B. The risk of material misstatement.
C. The extent to which judgment was required in performing the specific audit procedures.
D. The content of the representation letter.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The content of the representation letter will generally not affect the nature and extent of audit documentation. Factors affecting the nature and extent of audit documentation include:
1. The risk of material misstatement;
2. The extent to which judgment was required in performing the work and evaluating the results;
3. The nature of the specific auditing procedure;
4. The significance of the evidence obtained;
5. The nature and extent of any problems identified; and
6. The need to document conclusions that may not be obvious.

QUESTION 109
Which of the following 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 internal control.
B. A management representation letter that summarizes the timing and details of the auditor's planned fieldwork.
C. An indication in the audit documentation that the accounting records agree or reconcile with the financial statements.
D. A list of the procedures performed and the findings obtained.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The quantity, type, and content of audit documentation vary with the circumstances, but it should be sufficient to show that the accounting records agree or reconcile with the financial statements.
Choice "a" is incorrect. The auditor's understanding of internal control can be documented in a variety of different ways. Flowcharts and internal control questionnaires are two methods that might be used to assist the auditor in obtaining an understanding of internal control, but they generally do not provide information about the effectiveness of the entity's internal controls.
Choice "b" is incorrect. An engagement letter (and not a representation letter) summarizes the timing and details of the auditor's planned field work. Choice "d" is incorrect. A list of procedures and findings is required for an agreed-upon procedures engagement, not for an audit.

QUESTION 110
Audit documentation should be prepared in enough detail so that:

A. An experienced auditor who has worked with the client in the past can understand the procedures performed and the evidence obtained.
B. A reader of the financial statements who has no previous connection with the audit can understand the procedures performed and the evidence obtained.
C. A reader of the financial statements who has a background in financial analysis can understand the procedures performed and the evidence obtained.
D. An experienced auditor who has no previous connection with the audit can understand the procedures performed and the evidence obtained.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Audit documentation should be prepared in enough detail so that an experienced auditor who has no previous connection with the audit can understand the procedures performed and the evidence obtained.
Choice "a" is incorrect. The requirement is that audit documentation be detailed enough that an experienced auditor who has no previous connection with the audit can understand the procedures performed and the evidence obtained. This is a higher standard than simply requiring the audit documentation to be appropriate for an auditor who is already familiar with the client. Choices "b" and "c" are incorrect. Readers of the financial statements typically would not have access to the audit documentation.

QUESTION 111
Which of the following is not true about the report release date?

A. It is defined as the date after which existing documentation must not be deleted, and additions to the documentation file must be documented as such.
B. It is often the date on which the report is delivered to the client.
C. It is the date on which the auditor grants the client permission to use the report.
D. It is used to define the beginning of the retention period.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
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Choice "a" is correct. The documentation completion date (and not the report release date) is defined as the date after which existing documentation must not be deleted, and additions to the documentation file must be documented as such. Choice "b" is incorrect. The report release date is often the date on which the report is delivered to the client.

Choice "c" is incorrect. The report release date is the date on which the auditor grants the client permission to use the report. Choice "d" is incorrect. The report release date is used to define the beginning of the retention period.

QUESTION 112
Which best describes the documentation completion date?

A. Forty-five days from the report release date, based on PCAOB standards.
B. Sixty days from the report release date, based on PCAOB standards.
C. Seven years from the report release date, based on auditing standards.
D. Five years from the report release date, based on auditing standards.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
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Choice "a" is correct. According to PCAOB standards, the documentation completion date is forty-five days following the report release date.
Choice "b" is incorrect. According to auditing standards, the documentation completion date is sixty days following the report release date.
Choices "c" and "d" are incorrect. Seven years and five years refer to the required retention period under PCAOB standards and auditing standards, respectively.

QUESTION 113
An audit supervisor reviewed the work performed by the staff to determine if the audit was adequately performed. The supervisor accomplished this by primarily reviewing which of the following?

A. Checklists.
B. Working papers.
C. Analytical procedures.
D. Financial statements.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Audit documentation, or working papers, comprises the principal record of audit procedures performed, evidence obtained, and conclusions reached. Reviewing the working papers allows a supervisor to understand the work performed and the evidence obtained, and to evaluate whether the audit was adequately performed.
Choice "a" is incorrect. Checklists might be used within the audit documentation, but checklists alone would not provide a comprehensive record of the audit procedures performed, the evidence obtained, and conclusions reached.
Choice "c" is incorrect. Analytical procedures might be documented within the working papers, but such procedures alone would not provide a comprehensive record of the audit procedures performed, the evidence obtained, and conclusions reached.
Choice "d" is incorrect. Reviewing the financial statements would provide no information regarding the audit procedures performed, the evidence obtained, or conclusions reached, and therefore would provide no basis on which to review the work performed by the staff.

QUESTION 114
Which of the following circumstances most likely would cause an auditor to suspect that material misstatements exist in a client's financial statements?

A. The assumptions used in developing the prior year's accounting estimates have changed.
B. Differences between reconciliations of control accounts and subsidiary records are not investigated.
C. Negative confirmation requests yield fewer responses than in the prior year's audit.
D. Management consults with another CPA firm about complex accounting matters.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. If control accounts in the general ledger do not reconcile to the subsidiary ledgers, there may be a problem in the way transactions were recorded and posted. Failure to investigate such differences implies that, if such a problem exists, it has not been identified and corrected. The auditor would therefore suspect that material misstatements exist in the client's financial statements.
Choice "a" is incorrect. The assumptions used in developing accounting estimates generally do change as new information becomes available or as situations or conditions change. This would not necessarily indicate that a material misstatement exists.
Choice "c" is incorrect. Since responses to negative confirmations are only received when there are discrepancies, a lower response rate likely would be indicative of fewer problems with accounts receivable. This corresponds to a reduced likelihood of material misstatement.
Choice "d" is incorrect. Management's consultation with another CPA firm about complex accounting matters indicates proactive steps on the part of management to accurately address those matters. Material misstatements with respect to the complex accounting matters therefore would be less likely to exist.

QUESTION 115
Which of the following is a true statement regarding documentation requirements for analytical procedures?

A. When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor is required to document the reasons analytical procedures were performed instead of tests of details.
B. When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor is required to document his or her expectation and management's concurrence with that expectation.
C. When an analytical procedure is used during the overall review stage of the audit, the auditor is required to document the auditor's expectation and any additional procedures performed to investigate significant unexplained differences.
D. When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor is required to document both the auditor's expectation and the factors considered in developing that expectation.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor is required to document both the auditor's expectation and the factors considered in developing that expectation.
Choice "a" is incorrect. There is no requirement that the auditor document the reasons analytical procedures were performed instead of tests of details.
Choice "b" is incorrect. There is no requirement that the auditor document management's concurrence with the expectation.
Choice "c" is incorrect. When an analytical procedure is performed during the overall review stage, there are no specific documentation requirements. The requirement that the auditor document the expectation and any additional procedures performed to investigate significant unexplained differences relates to analytical procedures performed as principal substantive tests.

QUESTION 116
To be effective, analytical procedures in the overall review stage of an audit engagement should be performed by:

A. The staff accountant who performed the substantive auditing procedures.
B. The managing partner who has responsibility for all audit engagements at that practice office.
C. A manager or partner who has a comprehensive knowledge of the client's business and industry.
D. The CPA firm's quality control manager or partner who has responsibility for the firm's peer review program.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The manager and partner on a specific job generally bear a great deal of responsibility for the audit and the report. Typically they would perform analytical procedures during the final review stage, to evaluate overall financial statement presentation and to assess the conclusions reached. In order to evaluate the results of the analysis and to perform an effective review, the manager or partner should have a comprehensive knowledge of the client's business and the industry.
Choice "a" is incorrect. It is more effective to have a manager or partner perform this review rather than a staff accountant, because the manager or partner is generally more experienced and knowledgeable, and because it provides a double check on the work of the staff accountant.
Choices "b" and "d" are incorrect. The managing partner and the quality control manager or partner might not have a comprehensive knowledge of the client's business and industry.

QUESTION 117
Analytical procedures performed in the overall review stage of an audit suggest that several accounts have unexpected relationships. The results of these procedures most likely would indicate that:

A. Irregularities exist among the relevant account balances.
B. Internal control activities are not operating effectively.
C. Additional tests of details are required.
D. The communication with those charged with governance should be revised.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. If analytical procedures suggest unexpected relationships, the auditor would perform additional tests of details of the accounts involved.
Choice "a" is incorrect. The identification of unexpected relationships as a result of analytical procedures does not necessarily mean that irregularities exist in the relevant account balances, although this is a possible .
Choice "b" is incorrect. The identification of unexpected relationships as a result of analytical procedures does not necessarily mean that internal control activities are not operating effectively, although this is a possible . Choice "d" is incorrect. The identification of unexpected relationships as a result of analytical procedures does not necessarily mean that communication with those charged with governance should be revised, although this is a possible consequence.

QUESTION 118
Which of the following comparisons would an auditor most likely make in evaluating an entity's costs and expenses?

A. The current year's accounts receivable with the prior year's accounts receivable.
B. The current year's payroll expense with the prior year's payroll expense.

C. The budgeted current year's sales with the prior year's sales.
D. The budgeted current year's warranty expense with the current year's contingent liabilities.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. The most likely analytical review procedure involving costs and expenses would be to compare the current year's payroll expense (average amount per employee) to the prior year, taking into consideration an average increase in wage rates. This is a very effective technique in auditing payroll expense.
Choice "a" is incorrect. Comparing the current year's accounts receivable balance with the prior year provides little evidence because accounts receivable may fluctuate based on timing of cash payments, which is unpredictable.
Choice "c" is incorrect. Comparing the budgeted current year's sales with the prior year's sales provides evidence regarding the reasonableness of the current year sales budget, but does not provide evidence about costs and expenses. Choice "d" is incorrect. The current year's budgeted warranty expense would likely be compared to the current year's actual warranty expense, not to all of the contingent liabilities for the year.

QUESTION 119
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 audit documentation.
D. Increasing the level of detection risk.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The auditor relies on substantive tests to achieve audit objectives related to particular assertions. Analytical procedures are one type of substantive procedure.
Choice "b" is incorrect. CPA firms performing audits are required to adhere to a system of quality control, but adhering to such a system does not directly help

the firm achieve specific audit objectives.
Choice "c" is incorrect. Audit documentation is used to record the results of audit procedures that have been performed to achieve audit objectives. Mere preparation of audit documentation does not achieve audit objectives. Choice "d" is incorrect. Increasing the level of detection risk does not enable the auditor to achieve audit objectives related to a particular assertion.

QUESTION 120
An auditor's analytical procedures most likely would be facilitated if the entity:

A. Segregates obsolete inventory before the physical inventory count.
B. Uses a standard cost system that produces variance reports.
C. Corrects material weaknesses in internal control before the beginning of the audit.
D. Develops its data from sources solely within the entity.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. An auditor's analytical procedures are facilitated when an entity uses a standard cost system with variance reports because the comparison of actual to budget will already have been performed. In addition, it is likely that management will already be aware of significant variations from budget and will be better able to address any questions the auditor may have.
Choice "a" is incorrect. Segregation of obsolete inventory would not be an important factor in determining whether analytical procedures would be effective.
Choice "c" is incorrect. Correction of internal control weaknesses prior to the beginning of the audit would not affect analytical procedures.
Choice "d" is incorrect. Analytical procedures using data developed solely within the entity are not as reliable as analytical procedures using data developed externally.

QUESTION 121
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.

Correct Answer: B

Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Examination of accounts receivable and cash receipts provides the auditor with evidence with respect to both the completeness and the occurrence of sales transactions, thus limiting the need to test sales transactions. Choice "a" is incorrect. Examination of beginning and ending inventory balances may provide limited evidence of the occurrence of purchases and the cost of goods sold, but not of sales.
Choice "c" is incorrect. Examination of shipping and receiving activities would not necessarily reduce the testing of sales transactions.
Choice "d" is incorrect. Cutoffs of sales and purchases provides evidence regarding the sales occurring close to year-end, not necessarily all sales for the year.

QUESTION 122
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.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. By tracing from the shipping documents to the invoices, the auditor confirms that goods that were shipped were properly billed.
Choice "a" is incorrect. Tracing shipping documents to prenumbered invoices would not provide assurance that duplicate shipments or billings did not occur.
Choice "c" is incorrect. In order to test whether all goods that were ordered were shipped, the auditor would trace customer purchase orders to shipping documents. Choice "d" is incorrect. Determining that all prenumbered sales invoices are accounted for does not require examining shipping documents.

QUESTION 123
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 and allocation.

B. Existence.
C. Completeness.
D. Rights and obligations.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Assertions about valuation and allocation deal with whether assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts. Recalculation of the amortization and review of the amortization period would test the valuation and allocation assertion.
Choice "b" is incorrect. Assertions about existence deal with whether assets, liabilities, and equity interests exist at a given date. Evaluating amortization does not relate to this assertion.
Choice "c" is incorrect. Assertions about completeness deal with whether all assets, liabilities, and equity interests that should be presented in the financial statements are so included. Evaluating amortization does not relate to this assertion. Choice "d" is incorrect. Assertions about 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. Evaluating amortization does not relate to this assertion.

QUESTION 124
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 activities 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.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The objective of analytical procedures used in the overall review stage of the audit is to assist the auditor in assessing conclusions reached and in the evaluation of the overall financial statement presentation. Analytical procedures applied in the overall review stage are used to consider the adequacy of evidence gathered in response to unusual or unexpected balances identified in planning the audit, and to identify unusual or unexpected balances or

relationships that were not previously identified.
Choice "a" is incorrect. If analytical procedures are used to gather evidence about account balances that have not changed from last year, they are functioning as a substantive test rather than as a final review procedure. Choice "b" is incorrect. Analytical procedures are not used to test controls.
Choice "d" is incorrect. If analytical procedures are used as a test of transactions, they are functioning as a substantive test rather than as a final review procedure.

QUESTION 125
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.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Analytical procedures involve comparison of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. Projecting an error rate from a statistical sample does not involve such a comparison.
Choice "a" is incorrect. An analytical procedure involves comparison of an independently developed expectation to a recorded amount. Comparing an estimate of payroll expense (developed by multiplying the number of employees by the average hourly rate and the total hours worked) to the recorded expense is an analytical procedure.
Choice "c" is incorrect. An analytical procedure involves comparison of an independently developed expectation to a recorded amount. Ratio analysis is often performed in order to compare recorded results to industry norms or to past performance, and therefore calculation of accounts receivable turnover is likely to be an analytical procedure.
Choice "d" is incorrect. An analytical procedure involves comparison of an independently developed expectation to a recorded amount. Comparing an estimate of sales (developed based on a trend analysis) to the recorded amount is an analytical procedure.

QUESTION 126
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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. To audit the statement of cash flows, the auditor reconciles the amounts on the statement to amounts on other financial statements.
Choice "a" is incorrect. Comparison of amounts on the cash flow statement with those of the previous period is an analytical procedure that is not commonly used to audit the statement of cash flows, since sources and uses of cash in the current year are not necessarily predictable based on sources and uses from the prior year.
Choice "b" is incorrect. Reconciling the cutoff bank statement is a procedure used to audit the cash balance, rather than the statement of cash flows. Choice "c" is incorrect. Vouching all bank transfers is a procedure used to audit the cash balance, rather than the statement of cash flows.

QUESTION 127
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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Long-term debt that matures within one year is reported as a current liability on the balance sheet. An auditor reviews changes in long-term debt occurring after year-end to evaluate whether such debt is appropriately classified on the balance sheet.
Choice "a" is incorrect. Subsequent changes in employee pay rates are not relevant to the current year's audit report.
Choice "b" is incorrect. Depreciation charges for assets sold in the subsequent period are not relevant to the current year's audit report.
Choice "c" is incorrect. Payroll checks that were recorded close to (but before) year-end often are not cashed until the subsequent period. The auditor would not be particularly concerned about this.

QUESTION 128
Which of the following presumptions is correct about the reliability of audit evidence?

A. Information obtained indirectly from outside sources is the most reliable evidential matter.
B. To be reliable, audit evidence should be conclusive rather than persuasive.
C. Reliability of audit evidence refers to the amount corroborative evidence obtained.
D. An effective internal control structure provides more assurance about the reliability of audit evidence.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Reliability of audit evidence is enhanced by a satisfactory internal control structure.
Choice "a" is incorrect. Information obtained directly from outside sources is more reliable than that obtained indirectly.
Choice "b" is incorrect. In the great majority of cases, the auditor finds it necessary to rely on evidence that is persuasive rather than conclusive. Choice "c" is incorrect. The amount of corroborative evidence obtained refers to the sufficiency of the evidence, not its reliability.

QUESTION 129
For audits of financial statements made in accordance with generally accepted auditing standards, the use of analytical procedures is required to some extent:

	As a substantive test	*In the final review stage*
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Analytical procedures are required to be applied to some extent in planning and in the final review stage. In addition, although not required, analytical procedures may be used as a substantive test when they are more effective or efficient than tests of details.
Choices "a", "b", and "d" are incorrect, per the above .

QUESTION 130
Which of the following ratios would an engagement partner most likely calculate when reviewing the balance sheet in the overall review stage of an audit?

A. Quick assets/current assets.
B. Accounts receivable/inventory.
C. Interest payable/interest receivable.
D. Total debt/total assets.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. During the final review stage of an audit, the auditor focuses on the overall presentation of the financial statements. Total debt/total assets indicates the portion of assets financed by creditors, which is a meaningful ratio to calculate during the final audit review.
Choice "a" is incorrect. Quick assets/current assets simply indicates the percentage of current assets that are also "quick" assets. It is not a particularly meaningful ratio.
Choice "b" is incorrect. Accounts receivable/inventory is not a meaningful ratio because it compares a figure based on retail dollars with a cost-based figure.
Choice "c" is incorrect. Interest payable/interest receivable is not a meaningful ratio because these two amounts are not related.

QUESTION 131
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.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. The appropriate numerator for calculating inventory turnover is cost of goods sold.
Cost of goods sold is the expense most clearly associated with the sale (turnover) of inventory, which is priced at acquisition cost, not selling price.
Choice "a" is incorrect. Net sales is a measure of revenue that reflects the price at which inventory was sold, not its recorded inventoriable value.
Choice "c" is incorrect. Operating income does not tie specifically to the recorded value of inventory sold because it reflects the sales price after all operating expenses. Choice "d" is incorrect. Gross sales is a measure of revenue that reflects the price at which inventory was sold, not its recorded inventoriable value.

QUESTION 132
What effect would the sale of a company's trading securities at their carrying amounts for cash have on each of the following ratios?

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Trading securities are both current assets and quick assets. If they are sold for their carrying value, then both total current assets and total quick assets remain constant since one type of current asset and quick asset is traded for another. Thus, both the current ratio and the quick ratio would be unaffected by the sale of trading securities. Choices "b", "c", and "d" are incorrect, per the above .

QUESTION 133

The following data pertain to Cowl, Inc., for the year ended December 31, 20X4:

What was Cowl's rate of return on assets for 20X4?

A. 5%
B. 6%
C. 20%
D. 24%

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Rate of return on assets is defined as the net income divided by the average total assets. In this case:
$150,000 / [($2,000,000 + $3,000,000)/2] or [$150,000 / $2,500,000] = 6% rate of return.
Choice "a" is incorrect. Average total assets ($2,500,000) should be used, not ending assets ($3,000,000).
Choice "c" is incorrect. Net income ($150,000) and average total assets ($2,500,000) should be used, not net sales ($600,000) and ending assets ($3,000,000).
Choice "d" is incorrect. Net income ($150,000) should be used, not net sales ($600,000).

QUESTION 134
Selected data pertaining to Lore Co. for the calendar year 20X4 is as follows:

Net cash sales	$ 3,000
Cost of goods sold	18,000
Inventory at beginning of year	6,000
Purchases	24,000
Accounts receivable at beginning of year	20,000
Accounts receivable at end of year	22,000

The accounts receivable turnover for 20X4 was 5.0 times. What were Lore's 20X4 net credit sales?

A. $105,000
B. $107,000

C. $110,000
D. $210,000

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The accounts receivable turnover ratio equals net credit sales divided by average accounts receivable. 5.0 = net credit sales / [($20,000 + $22,000)/2]. Net credit sales equal $105,000.
Choice "b" is incorrect. The accounts receivable turnover ratio equals net credit sales divided by average accounts receivable.
Choice "c" is incorrect. The accounts receivable turnover ratio equals net credit sales divided by average accounts receivable, not by year-end accounts receivable.
Choice "d" is incorrect. The accounts receivable turnover ratio equals net credit sales divided by average accounts receivable, not by the sum of beginning and ending accounts receivable.

QUESTION 135
Selected data pertaining to Lore Co. for the calendar year 20X4 is as follows:

Net cash sales	$ 3,000
Cost of goods sold	18,000
Inventory at beginning of year	6,000
Purchases	24,000
Accounts receivable at beginning of year	20,000
Accounts receivable at end of year	22,000

What was the inventory turnover for 20X4?

A. 1.2 times.
B. 1.5 times.
C. 2.0 times.
D. 3.0 times.

Correct Answer: C

Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Inventory turnover equals cost of goods sold divided by average inventory.
Beginning inventory ($6,000) plus purchases ($24,000) less ending inventory equals cost of goods sold ($18,000). Thus, ending inventory equals $12,000 and inventory turnover = $18,000 / [($6,000 + $12,000)/2] = 2.0. Choice "a" is incorrect. Inventory turnover equals cost of goods sold divided by average inventory.
Choice "b" is incorrect. Cost of goods sold should be divided by average inventory, not by ending inventory.
Choice "d" is incorrect. Cost of goods sold should be divided by average inventory, not by beginning inventory.

QUESTION 136
Selected data pertaining to Lore Co. for the calendar year 20X4 is as follows:

Net cash sales	$ 3,000
Cost of goods sold	18,000
Inventory at beginning of year	6,000
Purchases	24,000
Accounts receivable at beginning of year	20,000
Accounts receivable at end of year	22,000

Lore would use which of the following to determine the average days sales in inventory?

	Numerator	Denominator
A.	365	Average inventory
B.	365	Inventory turnover
C.	Average inventory	Sales divided by 365
D.	Sales divided by 365	Inventory turnover

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Average number of days sales in inventory is defined as 365 days per year divided by the inventory turnover.
Choice "a" is incorrect. The denominator used to determine average days sales in inventory is inventory turnover. Inventory turnover is cost of goods sold divided by average inventory, not simply average inventory. Choice "c" is incorrect. The days sales in inventory calculation uses the cost of goods sold figure, not the sales figure. Choice "d" is incorrect. The days sales in inventory calculation uses 365 in the numerator, not sales divided by 365.

QUESTION 137
In analyzing a company's financial statements, which financial statement would a potential investor primarily use to assess the company's liquidity and financial flexibility?

A. Balance sheet.
B. Income statement.
C. Statement of retained earnings.
D. Statement of cash flows.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Liquidity ratios and coverage ratios focus on balance sheet account balances.
Choice "b" is incorrect. Income statement information is primarily used for profitability analysis.
Choice "c" is incorrect. The statement of retained earnings is primarily a reconciliation of the retained earnings account. Choice "d" is incorrect. The statement of cash flows assesses cash inflows and cash outflows.

QUESTION 138
At December 30, 20X3, Vida Co. had cash of $200,000, a current ratio of 1.5:1 and a quick ratio of .5:1.
On December 31, 20X3, all cash was used to reduce accounts payable. How did these cash payments affect the ratios?

Current ratio	Quick ratio
A. Increased	Decreased
B. Increased	No effect
C. Decreased	Increased
D. Decreased	No effect

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The current ratio equals current assets divided by current liabilities. Since the current assets exceed the current liabilities (as evidenced by a current ratio of 1.5:1), when each is decreased by the same amount, there will be a greater percentage reduction of the current liabilities.
Thus, the ratio will increase since the current assets are now proportionately larger than the current liabilities. The quick ratio equals quick assets (including cash) divided by current liabilities. Since the quick assets are less than the current liabilities (as evidenced by a quick ratio of .5:1), when each is decreased by the same amount, the percentage decrease of the quick assets will be greater than that of the current liabilities. Thus, the ratio will decrease since the quick assets are now proportionately smaller than the current liabilities. Choices "b", "c", and "d" are incorrect, per the above .

QUESTION 139
At December 31, 20X2, Curry Co. had the following balances in selected asset accounts:

	20X2	Increase over 20X1
Cash	$ 300	$100
Accounts receivable, net	1,200	400
	30	
Inventory	500	200
Prepaid expenses	100	40
Other assets	400	150
Total assets	$2,500	$890

Curry also had current liabilities of $1,000 at December 31, 20X2, and net credit sales of $7,200 for the year then ended.
What is Curry's acid-test ratio at December 31, 20X2?

A. 1.5
B. 1.6
C. 2.0
D. 2.1

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The acid-test ratio is calculated by taking the current assets excluding inventory and prepaid expenses and dividing by current liabilities. In this case, cash and accounts receivable ($300 + $1,200 = $1,500) are divided by current liabilities ($1,000), resulting in a ratio of $1,500/$1,000, or 1.5.
Choice "b" is incorrect. The numerator in the acid-test ratio formula includes only cash and accounts receivable. It would not include prepaid expenses.
Choice "c" is incorrect. The numerator in the acid-test ratio formula includes only cash and accounts receivable. It would not include inventory.
Choice "d" is incorrect. The numerator in the acid-test ratio formula includes only cash and accounts receivable. It would not include inventory and prepaid expenses.

QUESTION 140
At December 31, 20X2, Curry Co. had the following balances in selected asset accounts:

	20X2	Increase over 20X1
Cash	$ 300	$100
Accounts receivable, net	1,200	400
Inventory	500	200
Prepaid expenses	100	40
Other assets	400	150
Total assets	$2,500	$890

Curry also had current liabilities of $1,000 at December 31, 20X2, and net credit sales of $7,200 for the year then ended. What was the average number of days to collect Curry's accounts receivable during 20X2?

A. 30.4
B. 40.6
C. 50.7
D. 60.8

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The average number of days to collect accounts receivable is calculated by dividing 365 days by the accounts receivable turnover. Accounts receivable turnover is net credit sales divided by the average accounts receivable:

Average A/R = (beginning A/R + ending A/R) ÷ 2 = ($1,200 + $800) ÷ 2 = $1,000
A/R turnover = $7,200 ÷ $1,000 = 7.2
Average number of days in A/R = 365 days ÷ 7.2 = 50.7 days.

Choice "a" is incorrect. The denominator should be net credit sales ($7,200) divided by average receivables $1,000), or 7.2, not 12.
Choice "b" is incorrect. The average receivable balance is $1,000, not $800. The right-hand column shows the increase over 20X1, so the 20X1 receivable balance was $1,200 âˆ' $400, or $800. Since the 20X2 receivable balance was given as $1,200, the average receivable balance is $1,000.
Choice "d" is incorrect. Average inventory ($1,000), not ending inventory ($1,200), should be used.

QUESTION 141
An independent auditor asked a client's internal auditor to assist in preparing a standard financial institution confirmation request for a payroll account that had been closed during the year under audit. After the internal auditor prepared the form, the controller signed it and mailed it to the bank. What was the major flaw in this procedure?

A. The internal auditor did not sign the form.
B. The form was mailed by the controller.
C. The form was prepared by the internal auditor.
D. The account was closed, so the balance was zero.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. The auditor should control the mailing of independent confirmations.
Choice "a" is incorrect. It is appropriate for a member of management, such as the controller, to sign the confirmation request.
Choice "c" is incorrect. It is acceptable for an internal auditor to provide direct assistance to the external auditor, such as by preparing confirmation forms.
Choice "d" is incorrect. Confirmations may be sent to accounts that show a zero balance, to test for understatement errors or to obtain information about loans.

QUESTION 142
Analytical procedures performed in the final review stage of an audit generally would include:

A. Reassessing the factors that assisted the auditor in deciding on preliminary materiality levels and audit risk.
B. Considering the adequacy of the evidence gathered in response to unexpected balances identified in planning.
C. Summarizing uncorrected misstatements specifically identified through tests of details of transactions and balances.
D. Calculating projected uncorrected misstatements estimated through audit sampling techniques.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Analytical procedures applied during the final review stage should be used to determine whether adequate evidence has been gathered in response to unusual or unexpected balances identified during the audit.
Choice "a" is incorrect. Analytical procedures generally involve comparison of recorded amounts to auditor expectations. Reassessing the factors used to establish materiality levels and audit risk would not involve such comparisons.
Choice "c" is incorrect. Analytical procedures generally involve comparison of recorded amounts to auditor expectations. Summarizing uncorrected misstatements would not involve such comparisons.
Choice "d" is incorrect. Analytical procedures generally involve comparison of recorded amounts to auditor expectations. Calculating projected uncorrected misstatements would not involve such comparisons.

QUESTION 143
Which of the following types of audit evidence generally is the most reliable?

A. Inquiries made of management.
B. Confirmation of account information.
C. Analytical procedures.
D. Review of prior-year audit procedures.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Confirmations are among the most reliable types of evidence, as they constitute external evidence sent directly to the auditor.
Choice "a" is incorrect. Inquiries provide oral evidence, which is less reliable than confirmations.
Choice "c" is incorrect. Analytical procedures provide the auditor with direct personal knowledge, but because these procedures often are based on internal accounting data, the evidence obtained is not as reliable as that obtained from confirmations.
Choice "d" is incorrect. Review of audit procedures from the previous year does not provide appropriate audit evidence regarding the current year's financial statements.

QUESTION 144
An auditor compares annual revenues and expenses with similar amounts from the prior year and investigates all changes exceeding 10%. This procedure most likely could indicate that:

A. Fourth quarter payroll taxes were properly accrued and recorded, but were not paid until early in the subsequent year.
B. Unrealized gains from increases in the value of available-for-sale securities were recorded in the income account for trading securities.
C. The annual provision for uncollectible accounts expense was inadequate because of worsening economic conditions.
D. Notice of an increase in property tax rates was received by management, but was not recorded until early in the subsequent year.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Unrealized gains on available-for-sale securities should properly be recorded in other comprehensive income. If such gains were erroneously recorded in the income account for trading securities, this might be discovered through comparison of the current year and prior year revenues and expenses (assuming the error occurred only in the current year, and not in the prior year).
Choice "a" is incorrect. If payroll taxes were properly accrued and recorded, there is unlikely to be a significant change in revenues and expenses for the current year as compared to the prior year. Payables would not be part of the comparison of revenues and expenses.
Choice "c" is incorrect. In times of worsening economic conditions, one would expect the annual provision for uncollectible accounts to increase. Since this answer option indicates that the provision was inadequate, it would appear that the client did not increase the provision appropriately. Investigating changes in revenues and expenses would not be likely to identify this error, since failing to increase the provision would likely result in there being little change between the two years.
Choice "d" is incorrect. An increase in property tax rates should cause a corresponding increase in accrued property tax expense; however, the question-indicates that the appropriate increase was not recorded in the current year. Investigating changes in revenues and expenses would not be likely to identify this error, since failing to increase the expense would likely result in there being little change between the two years.

QUESTION 145
An auditor most likely would apply analytical procedures in the overall review stage of an audit to:

A. Enhance the auditor's understanding of subsequent events.
B. Identify auditing procedures omitted by the staff accountants.
C. Determine whether additional audit evidence may be needed.
D. Evaluate the effectiveness of the internal control activities.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. In performing analytical procedures as an overall review, the auditor determines whether adequate evidence has been gathered in response to unusual or unexpected balances identified during the audit, and may decide that additional audit procedures are warranted. In addition, the auditor may identify unusual or unexpected balances not already noted during the audit, which would also require the application of further auditing procedures.
Choice "a" is incorrect. Analytical procedures applied during the overall review stage of the audit are meant to evaluate the overall financial statement presentation, and to assess the conclusions reached by the auditor. This is a high-level review, and one that focuses on the financial statements. As such, it would not be likely to enhance the auditor's understanding of subsequent events.
Choice "b" is incorrect. Analytical procedures applied during the overall review stage of the audit are meant to evaluate the overall financial statement presentation, and to assess the conclusions reached by the auditor. This is a high-level review, and one that focuses on the financial statements. As such, it would not be likely to identify omitted auditing procedures.
Choice "d" is incorrect. Analytical procedures applied during the overall review stage of the audit are meant to evaluate the overall financial statement presentation, and to assess the conclusions reached by the auditor. This is a high-level review, and one that focuses on the financial statements. As such, it would not be useful in evaluating the effectiveness of the client's internal control activities.

QUESTION 146
Analytical procedures performed during an audit indicate that accounts receivable doubled since the end of the prior year. However, the allowance for doubtful accounts as a percentage of accounts receivable remained about the same. Which of the following client s would satisfy the auditor?

A. A greater percentage of accounts receivable are listed in the "more than 120 days overdue" category than in the prior year.
B. Internal control activities over the recording of cash receipts have been improved since the end of the prior year.
C. The client opened a second retail outlet during the current year and its credit sales approximately equaled the older outlet.
D. The client tightened its credit policy during the current year and sold considerably less merchandise to customers with poor credit ratings.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. If a second, similar retail outlet were opened, one would expect sales and accounts receivable to double. As long as the collection rates for the new outlet's receivables were expected to be similar to those of the original outlet, the allowance for doubtful accounts as a percentage of accounts receivable would remain the same.
Choice "a" is incorrect. If more receivables are potentially uncollectible in the current year (as opposed to the prior year), the allowance for doubtful accounts as a percentage of receivables should increase to reflect the greater level of estimated bad debts.
Choice "b" is incorrect. Improved control activities related to the recording of cash receipts might result in a decrease in accounts receivable in the current year

as compared to the prior year, not an increase. In addition, improving such controls would not be likely to affect the allowance for doubtful accounts as a percentage of receivables.
Choice "d" is incorrect. If the client sold less merchandise to customers with poor credit ratings, the allowance for doubtful accounts as a percentage of receivables should decrease to reflect the lower level of estimated bad debts.

QUESTION 147
The most reliable procedure for an auditor to use to test the existence of a client's inventory at an outside location would be to:

A. Observe physical counts of the inventory items.
B. Trace the total on the inventory listing to the general ledger inventory account.
C. Obtain a confirmation from the client indicating inventory ownership.
D. Analytically compare the current-year inventory balance to the prior-year balance.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The auditor's personal observation is generally one of the most reliable forms of evidence. Observing physical inventory counts provides reliable evidence that the inventory actually exists.
Choice "b" is incorrect. Tracing totals from the inventory listing to the general ledger inventory account provides evidence of completeness, not existence.
Choice "c" is incorrect. A confirmation from the client indicating ownership provides some evidence regarding rights and obligations, but does not provide evidence of existence.
Choice "d" is incorrect. Analytical comparisons of current year to prior year inventory balances might provide some evidence regarding completeness, existence, and valuation, but this is not as reliable a procedure for verifying existence as is the auditor's direct personal observation.

QUESTION 148
An auditor compared the current-year gross margin with the prior-year gross margin to determine if cost of sales is reasonable. What type of audit procedure was performed?

A. Test of transactions.
B. Analytical procedures.
C. Test of controls.
D. Test of details.

Correct Answer: B

Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Analytical procedures are evaluations of financial information made by a study of plausible relationships among data, and they include comparisons between current year and prior year financial information.
Choice "a" is incorrect. Tests of transactions involve selecting specific transactions and evaluating whether they were properly recorded. Comparing current year and prior year gross margin would not provide information regarding specific transactions.
Choice "c" is incorrect. Tests of controls are performed to evaluate the effectiveness of controls.
Comparing current year and prior year gross margin would not provide information regarding controls.
Choice "d" is incorrect. Test of details are audit procedures used to gather evidence to support specific account balances. Comparing current year and prior year gross margin does not provide much information regarding specific account balances, although it might identify an account balance worthy of further consideration.

QUESTION 149
Which of the following procedures would yield the most reliable evidence?

A. A scanning of trial balances.
B. An inquiry of client personnel.
C. A comparison of beginning and ending retained earnings.
D. A recalculation of bad debt expense.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The auditor's direct personal knowledge (obtained through observation, examination, inspection, or recalculation) is one of the most reliable forms of evidence.
Choice "a" is incorrect. Scanning of trial balances may indicate areas where more attention should be focused (e.g., unusual balances, zero balances, etc.), but would seldom provide reliable evidence in and of itself.
Choice "b" is incorrect. Inquiry of client personnel provides evidence that is not particularly reliable, which is why it often needs to be corroborated by the auditor.
Choice "c" is incorrect. A comparison of beginning and ending retained earnings may provide information about certain transactions and events (e.g., dividends, income, etc.), but would not in and of itself provide evidence supporting those items.

QUESTION 150
Which of the following procedures would be most effective in reducing attestation risk?

A. Discussion with responsible individuals.
B. Examination of evidence.
C. Inquiries of senior management.
D. Analytical procedures.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Evidence obtained directly by the accountant (e.g., through physical examination) provides more persuasive evidence than evidence obtained through inquiry, discussion, or analytical procedures, and therefore reduces attestation risk.
Choices "a", "c", and "d" are incorrect, based on the above .

QUESTION 151
Which of the following factors would most likely influence an auditor's consideration of the reliability of data when performing analytical procedures?

A. Whether the data were developed in a computerized or a manual accounting system.
B. Whether the data were prepared on the cash basis or in conformity with GAAP.
C. Whether the data were developed under a system with adequate controls.
D. Whether the data were processed in an online system or a batch entry system.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Strong, effective internal controls improve the reliability of data.
Choice "a" is incorrect. The type of accounting system used does not affect the reliability of data. Both computerized and manual accounting systems can

provide reliable data, as long as there are appropriate controls in place.
Choice "b" is incorrect. The accounting basis used does not affect the reliability of data. Reliable data may be provided regardless of whether the cash basis or accrual basis (GAAP) is used, as long as there are appropriate controls in place. Choice "d" is incorrect. The type of processing system used does not affect the reliability of data. Both online systems and batch systems can provide reliable data, as long as there are appropriate controls in place.

QUESTION 152
At the conclusion of an audit, an auditor is reviewing the evidence gathered in support of the financial statements. With regard to the valuation of inventory, the auditor concludes that the evidence obtained is not sufficient to support management's representations. Which of the following actions is the auditor most likely to take?

A. Consult with the audit committee and issue a disclaimer of opinion.
B. Consult with the audit committee and issue a qualified opinion.
C. Obtain additional evidence regarding the valuation of inventory.
D. Obtain a statement from management supporting their inventory valuation.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. If an auditor has doubts about a material assertion (such as the valuation of inventory), he/she should gather sufficient evidence to eliminate the doubt.
Choices "a" and "b" are incorrect. The auditor would not consult with the audit committee regarding the sufficiency of audit evidence obtained, as this is determined based on the auditor's own judgment. In addition, if the auditor is able to obtain additional evidence, it might be possible to issue an unqualified opinion. Finally, even if no additional evidence is available, the auditor will still need to decide whether a qualified opinion or a disclaimer of opinion is more appropriate, depending on materiality.
Choice "d" is incorrect. Since management representations are in fact "statements from management," obtaining additional statements from management would not provide additional support.

QUESTION 153
Which of the following procedures would an auditor most likely perform in auditing the statement of cash flows?

A. Reconcile the amounts included in the statement of cash flows to the other financial statements' amounts.
B. Vouch a sample of cash receipts and disbursements for the last few days of the current year.
C. Reconcile the cutoff bank statement to the proof of cash to verify the accuracy of the year-end cash balance.
D. Confirm the amounts included in the statement of cash flows with the entity's financial institution.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. To audit the statement of cash flows, the auditor reconciles the amounts on the statement to amounts on other financial statements.
Choice "b" is incorrect. Vouching a sample of cash receipts and disbursements is a procedure used to audit the cash balance, rather than the statement of cash flows.
Choice "c" is incorrect. Reconciling the cutoff bank statement to the proof of cash to verify the accuracy of the year-end cash balance is a procedure used to audit the cash balance, rather than the statement of cash flows. Choice "d" is incorrect. Confirming cash amounts with the entity's financial institution is a procedure used to audit the cash balance, rather than the statement of cash flows.
Evidential Procedures for Selected Accounts

QUESTION 154
An auditor reviews the reconciliation of payroll tax forms that a client is responsible for filing in order to:

A. Verify that payroll taxes are deducted from employees' gross pay.
B. Determine whether internal control activities are operating effectively.
C. Uncover fictitious employees who are receiving payroll checks.
D. Identify potential liabilities for unpaid payroll taxes.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. An auditor reviews the reconciliation of payroll tax forms that a client is responsible for filing in order to identify potential liabilities for unpaid payroll taxes.
Choice "a" is incorrect. Payroll deductions are verified by inspecting the payroll register and, for a sample of employees, tracing deductions back to employee authorization forms held in the personnel department.
Choice "b" is incorrect. Review of the reconciliation of payroll tax forms is a substantive test that would not indicate whether internal control activities with respect to payroll are operating effectively.

Choice "c" is incorrect. Review of the reconciliation of payroll tax forms would not uncover fictitious employees. The auditor would need to observe payroll distribution (or examine direct deposits) to ensure that all personnel being paid are actually employed by the company.

QUESTION 155
An auditor discovered that a client's accounts receivable turnover is substantially lower for the current year than for the prior year. This may indicate that:

A. Fictitious credit sales have been recorded during the year.
B. Employees have stolen inventory just before the year-end.
C. The client recently tightened its credit-granting policies.
D. An employee has been lapping receivables in both years.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Recording fictitious sales generally has the same impact on revenues and receivables: both would be overstated by the same dollar amount. However, this will cause the accounts receivable turnover ratio to decrease, because the sales figure for the year is generally much larger than the average receivables amount. Since the numerator (sales) is being increased far less proportionately than is the denominator (receivables), overall the ratio will decline. (Try using actual numbers if you want to see how this works: Assume sales of $2,000,000 and average receivables of $300,000. What will happen to the ratio if you increase both of these numbers by $50,000? It will go from 6.7% to 5.9%--a decline.)
Choice "b" is incorrect. Inventory stolen by employees just before year-end would not affect the accounts receivable turnover ratio, which is calculated as net credit sales divided by average gross receivables.
Choice "c" is incorrect. A substantially lower accounts receivable turnover ratio may indicate collectability issues. This might be the result of the client loosening (not tightening) its credit-granting policies. Choice "d" is incorrect. If an employee has been lapping receivables in both years, the accounts receivable turnover ratio would not be substantially lower in one year compared to the other.

QUESTION 156
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.

Correct Answer: A

Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Some accounting systems facilitate the confirmation of single transactions rather than entire balances. In such cases, inclusion of statements of account showing details of the balances being confirmed makes it easier for the customers to confirm the balances, and therefore may improve the overall response rate.
Choice "b" is incorrect. Restricting the selection of accounts to be confirmed to those customers with large balances would not necessarily improve the response rate, as there is no particular relationship between balance size and the likelihood of response.
Choice "c" is incorrect. Requesting customers to respond to the confirmation requests electronically would not necessarily improve the response rate. It also might not be appropriate to request responses in electronic form, since the auditor will still request that the original be mailed back.
Choice "d" is incorrect. Notifying the recipients that second requests will be mailed would not necessarily improve the response rate, since the consequence of not responding (receiving a second request) is relatively minor.

QUESTION 157
In performing a count of negotiable securities, an auditor records the details of the count on a security count worksheet. What other information is usually included on this worksheet?

A. An acknowledgment by a client representative that the securities were returned intact.
B. An analysis of realized gains and losses from the sale of securities during the year.
C. An evaluation of the client's internal control concerning physical access to the securities.
D. A description of the client's procedures that prevent the negotiation of securities by just one person.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. After performing a count of negotiable securities, the auditor would generally obtain an acknowledgment from the client that the securities were returned intact. This helps maintain accountability for the securities, and reduces the likelihood of employee misappropriation (e.g., if a client employee were to steal a security and blame the auditor).
Choice "b" is incorrect. The auditor generally would not include an analysis of realized gains and losses on a security count worksheet, although this information would be included elsewhere in the audit documentation.
Choice "c" is incorrect. The auditor generally would not include an evaluation of the client's internal control on a security count worksheet, although this

information would be included elsewhere in the audit documentation.
Choice "d" is incorrect. The auditor generally would not include a description of the client's control procedures on a security count worksheet, although this information might be included elsewhere in the audit documentation.

QUESTION 158
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.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. E-mail responses to requests for confirmations of accounts receivable present a problem to the auditor, since the sender might not be as requested and the content might be altered. To reduce these risks, the auditor should request the senders to mail the original forms to the auditor.
Choice "b" is incorrect. Examination of subsequent cash receipts might be an acceptable alternative procedure, but it would not reduce the risks associated with accepting e-mail responses to requests for confirmations of accounts receivable.
Choice "c" is incorrect. Since the e-mail responses may be valid responses, the auditor should not consider them to be exceptions.
Choice "d" is incorrect. Mailing second requests to the e-mail respondents would not be necessary, since the sender did receive and respond to the first request. Requesting that the original confirmation be returned is a more likely response.

QUESTION 159
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	Understandability and classification
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Inspection of plant and equipment by the auditor provides evidence concerning the existence of the equipment; if the auditor can see it, it exists. However, physical inspection does not provide any evidence concerning whether the amounts paid for plant and equipment are properly presented, described, and disclosed. Only reviewing drafts of the financial statements will provide evidence regarding understandability and classification.
Choice "a" is incorrect. Physical inspection does not provide any evidence concerning whether the amounts paid for plant and equipment are properly presented, described, and disclosed.
Choice "c" is incorrect. Physical inspection of equipment does not provide any evidence concerning whether the amounts paid for the equipment are properly presented, described, and disclosed. Only reviewing drafts of the financial statements provides evidence regarding understandability and classification. However, inspection of plant and equipment by the auditor does provide evidence concerning the existence of the equipment; if the auditor can see it, it exists. Choice "d" is incorrect. Inspection of plant and equipment by the auditor does provide evidence concerning the existence of the equipment: if the auditor can see it, it exists.

QUESTION 160
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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Negative confirmations are most likely to be used when the assessed level of audit risk, including inherent and control risk, is low.
Choice "a" is incorrect. If the total amount of accounts receivable is immaterial, the auditor is not likely to send any confirmations.
Choice "b" is incorrect. If prior year response rates were low, negative confirmations would not be used since the auditor would be concerned that the negative confirmations would not receive adequate attention from the recipients. Choice "c" is incorrect. An auditor would need to feel comfortable that the confirmations would receive adequate attention from the recipients before deciding to send negative confirmations.

QUESTION 161
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.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Dividend income from investments is tested by referring to the dividend record books produced by investment advisory services, such as "Moody's Dividend Record." These books state the dividend that was declared and paid by the investee.
Choice "b" is incorrect. Stock indentures (initial stock agreements) published by corporate transfer agents discuss intent with respect to dividend declaration, but actual dividend declarations may vary. In addition, it is more efficient to use a single source (such as "Moody's") than to obtain and review stock indentures for each individual investment.

Choice "c" is incorrect. Stock ledgers maintained by independent registrars indicate how many shares of stock are issued and outstanding, and identify the shareholders of record, but they do not contain information concerning dividends. Choice "d" is incorrect. Annual audited financial statements of the investee companies give the total dividends paid, but there may not be enough information to determine exactly how much went to each type of stock and hence to each stockholder. In addition, it is more efficient to use a single source (such as "Moody's") than to obtain and review the financial statements of each investee.

QUESTION 162
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 safedeposit 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.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Joint custody by two company officials over assets like cash and marketable securities helps safeguard the assets. Under joint custody, collusion is required for a defalcation to occur.
Choice "a" is incorrect. Review of investment decisions made by the treasurer might reduce the probability of poor investment policies, but would not be likely to safeguard marketable securities after purchase.
Choice "c" is incorrect. Tracing purchases and sales from the subsidiary ledger to the general ledger would help ensure that all existing securities are recorded in the financial statements, but would not help safeguard marketable securities. Choice "d" is incorrect. An annual count by the chairman of the board might provide a small safeguard, but the infrequent performance of the control makes it a fairly weak one.

QUESTION 163
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.

Correct Answer: C
Section: Volume D

Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Since control risk is assessed at a low level, tests of controls would be required to evaluate the effectiveness of the internal controls to support that assessed level. Assuming controls are operating effectively, only limited substantive testing would be performed.
Choice "a" is incorrect. Extensive tests of property and equipment balances would not typically be required when control risk is assessed at a low level.
Choice "b" is incorrect. Since control risk is to be assessed at a low level, tests of controls would be required. Analytical procedures would not be particularly useful, since property and equipment transactions are subject to management discretion.
Choice "d" is incorrect. Analytical procedures would not be particularly useful, since property and equipment transactions are subject to management discretion. Year-end balances may therefore be unpredictable.

QUESTION 164
In determining the effectiveness of an entity's internal controls relating to the 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.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The occurrence assertion as it relates to payroll transactions would correspond to an audit objective to determine that payroll transactions actually occurred (i.e., that all payroll checks were issued to valid employees for hours actually worked). Segregation of duties between personnel and payroll departments is an important control to ensure that only valid employees receive paychecks.
Choice "b" is incorrect. Inspecting evidence related to prenumbering of payroll checks would relate to the completeness assertion.
Choice "c" is incorrect. Recomputing payroll deductions is a substantive test related to the accuracy assertion.
Choice "d" is incorrect. Verifying the preparation of the monthly payroll account bank reconciliation would provide significant evidence for the accuracy assertion for payroll transactions.

QUESTION 165

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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Testing to see whether equipment listed in the accounting records is physically present in the plant and still in service is an effective way to test whether unrecorded disposals occurred.
Choice "a" is incorrect. Tracing from equipment found in service to accounting records would be performed to test the completeness assertion that all equipment on hand has been recorded, rather than testing the assertion that all recorded equipment is still in service.
Choice "b" is incorrect. Reviewing whether depreciation is still being taken would not provide evidence about unrecorded fixed asset disposals unless the auditor also performs a physical inspection of the assets being depreciated. Also, assets that are fully depreciated but still in service would not appear in depreciation records.
Choice "c" is incorrect. Examining additions to the other assets account would not be likely to lead to discovery of unrecorded fixed asset disposals, since newer assets are not likely to have been retired.

QUESTION 166
The confirmation of customers' accounts receivable rarely provides reliable evidence about the completeness assertion because:

A. Many customers merely sign and return the confirmation without verifying its details.
B. Recipients usually respond only if they disagree with the information on the request.
C. Customers may not be inclined to report understatement errors in their accounts.
D. Auditors typically select many accounts with low recorded balances to be confirmed.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The completeness assertion states that all transactions that should be recorded are recorded. Accounts receivable confirmations rarely provide evidence about completeness since the recipients of the confirmations have a vested interest in not reporting understatements (i.e., transactions that have not been recorded).
Choice "a" is incorrect. While some customers may sign and return a confirmation without proper consideration, this is not the reason why confirmations do not provide evidence about the completeness assertion relative to other assertions. Choice "b" is incorrect. If customers respond whenever they disagree with information printed on the confirmation, they would report both understatements and overstatements, in which case confirmations would provide evidence about completeness. However, this is not what the auditor usually sees -- respondents are less likely to report understatement errors.
Choice "d" is incorrect. The balance of the account is not a relevant factor in determining whether the completeness assertion is tested by sending confirmations. If there are many accounts with low balances, the auditor may decide to send negative confirmations.

QUESTION 167
Which of the following s most likely would satisfy an auditor who questions management about significant debits to the accumulated depreciation accounts?

A. The estimated remaining useful lives of plant assets were revised upward.
B. Plant assets were retired during the year.
C. The prior year's depreciation expense was erroneously understated.
D. Overhead allocations were revised at year-end.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. A debit to accumulated depreciation decreases the balance in that account. The retirement of plant assets necessitates the removal (decrease) of accumulated depreciation related to the retired asset by debiting accumulated depreciation.
Choice "a" is incorrect. Remember that correction of an estimate is given prospective, not retroactive, treatment. Therefore, there would not be any decrease in the accumulated depreciation taken in previous years, although future credits would be lower than previous credits had been.
Choice "c" is incorrect. If the prior year's depreciation expense were understated (i.e., too low), the entry to correct the error would be a credit to accumulated depreciation. Choice "d" is incorrect. Revision of overhead allocations would not result in a debit to accumulated depreciation.

QUESTION 168
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.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Significant unexplained variances between standard and actual labor costs may cause the auditor to suspect an employee payroll fraud scheme.
Choice "b" is incorrect. Payroll checks generally are disbursed by the same person (or the same department) each payday, and this would not cause the auditor to suspect an employee payroll fraud scheme.
Choice "c" is incorrect. Time card approval by departmental supervisors is a standard practice, and would not raise an auditor's suspicions of a payroll fraud scheme. Choice "d" is incorrect. Maintenance of a separate payroll bank account is a standard practice, and would not raise an auditor's suspicions of a payroll fraud scheme.

QUESTION 169
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.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The independent auditor's direct personal knowledge, based on personal inquiry and observation, are auditing procedures commonly used to test segregation of duties.
Choice "b" is incorrect. Test counts and cutoff procedures represent substantive tests, and they would not be used to test segregation of duties.
Choice "c" is incorrect. Analytical procedures and invoice recomputation represent substantive tests, and they would not be used to test segregation of duties.

Choice "d" is incorrect. Document inspection and reconciliation represent substantive tests, and they would not be used to test segregation of duties.

QUESTION 170
An auditor most likely would inspect loan agreements under which an entity's inventories are pledged to support management's financial statement assertion of completeness with respect to:

A. Presentation and disclosure.
B. Transactions and events.
C. Account balances.
D. All of the above.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Inspecting loan agreements under which an entity's inventories are pledged provides evidence regarding completeness with respect to presentation and disclosure, since such information must be disclosed in the financial statements.
Choices "b", "c", and "d" are incorrect. Inspecting loan agreements under which an entity's inventories are pledged does not provide information regarding the completeness of transactions, events, or account balances.

QUESTION 171
Tests designed to detect purchases made before the end of the year that have been recorded in the subsequent year most likely would provide assurance about management's assertion regarding:

A. Accuracy.
B. Obligations.
C. Cutoff.
D. Classification.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. If purchases made before the end of the year have been recorded in the subsequent year, inventory will not be complete. The auditor uses cutoff tests to detect such situations and to determine that inventory quantities include all products, materials and supplies owned by the company. (Note that the cutoff assertion is closely related to the completeness and occurrence assertions.)
Choice "a" is incorrect. Assertions about accuracy deal with whether data related to recorded transactions has been included in the financial statements at appropriate amounts. Cutoff tests do not provide evidence related to the accuracy assertion for purchases.
Choice "b" is incorrect. Assertions about obligations deal with account balances, not with transactions and events.
Choice "d" is incorrect. Assertions about classification deal with whether particular components of the financial statements are properly presented, described, and disclosed. Cutoff tests would not provide evidence relevant to classification.

QUESTION 172
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 and allocation.
B. Rights and obligations.
C. Existence.
D. Understandability and classification.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. An audit objective for inventory valuation and allocation is to determine that slow moving, excess, defective and obsolete items included in inventory are properly identified. Inquiries of production and sales personnel concerning possible excess or obsolete inventory items would support management's assertion of valuation and allocation.
Choice "b" is incorrect. Assertions about 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.
Choice "c" is incorrect. Assertions about existence deal with whether assets, liabilities, and equity interests exist at a given date.
Choice "d" is incorrect. Assertions about understandability and classification deal with whether particular components of the financial statements are properly presented, described, and disclosed.

QUESTION 173
Which of the following statements is correct concerning the use of negative confirmation requests?

A. Unreturned negative confirmation requests rarely provide significant explicit evidence.
B. Negative confirmation requests are effective when detection risk is low.
C. Unreturned negative confirmation requests indicate that alternative procedures are necessary.
D. Negative confirmation requests are effective when understatements of account balances are suspected.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Although returned negative confirmations may provide evidence about the financial statement assertions, unreturned negative confirmation requests do not provide explicit evidence that the intended third parties received the confirmation requests and verified that the information contained in them is correct.
Choice "b" is incorrect. Negative confirmation requests may be used when the combined assessed level of inherent and control risk is low, which would generally imply that a somewhat higher level of detection risk could be accepted.
Choice "c" is incorrect. Alternative procedures are necessary only for unreturned positive confirmation requests. Unreturned negative confirmation requests generally imply that the respondent agrees with the stated balance.
Choice "d" is incorrect. Accounts receivable confirmations in general provide little assurance when understatements of account balances are suspected, since recipients have a vested interest in not reporting such understatements.

QUESTION 174
When an auditor does not receive replies to positive requests for year-end accounts receivable confirmations, the auditor most likely would:

A. Inspect the allowance account to verify whether the accounts were subsequently written off.
B. Increase the assessed level of detection risk for the valuation and completeness assertions.
C. Ask the client to contact the customers to request that the confirmations be returned.
D. Increase the assessed level of inherent risk for the revenue cycle.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. When using positive confirmation requests, the auditor should generally follow up with a second and sometimes third request to those parties from whom replies have not been received.
In addition, asking the client to contact its customers may encourage further responses.
Choice "a" is incorrect. Confirmations are designed to provide evidence of existence, so nonresponses would require alternative procedures focused on existence as well. Verification that the account was subsequently written off tests the valuation assertion, but does not provide evidence of existence.
Choice "b" is incorrect. The auditor sets detection risk based on the assessed levels of inherent risk and control risk, and would only increase the acceptable level of detection risk in response to a decrease in inherent or control risk. Failure to receive confirmations would not cause the auditor to make such a change.
Choice "d" is incorrect. Inherent risk assessments would not be affected by confirmation response rates, which are not subject to client control.

QUESTION 175
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:

A. Individual overdue balances.
B. Individual invoices.
C. Small account balances.
D. Large account balances.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. The auditor should consider the nature of the information requested when determining the sampling unit for the current year audit. Certain respondents' accounting systems may facilitate the confirmation of single transactions rather than of entire balances.
Choice "a" is incorrect. The auditor would not limit the population to overdue balances, since current balances can also be misstated.
Choices "c" and "d" are incorrect. Defining the sampling unit based on account size would not address the problem that caused differences during the prior year.

QUESTION 176
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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Failure to record sales returns would result in actual inventory quantities being greater than those recorded in the perpetual inventory records.
Choice "a" is incorrect. Failure to record purchase discounts would result in a difference in recorded costs, rather than recorded quantities.
Choice "b" is incorrect. Failure to record purchase returns would result in actual inventory quantities being less than those recorded in the perpetual inventory records. Choice "c" is incorrect. Failure to record sales would result in actual inventory quantities being less than those recorded in the perpetual inventory records.

QUESTION 177
When control risk is assessed as low for assertions related to payroll, substantive tests 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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. If the control risk is assessed as low, less substantive testing is necessary. In such an instance, substantive testing would normally be limited to analytical procedures and recalculating yearend accruals.
Choice "a" is incorrect. Observing distribution of paychecks is a test of controls, not a substantive test.
Choice "b" is incorrect. Footing and crossfooting the payroll register is an important substantive test, but it is limited in its effectiveness. Even if control risk is

assessed as low, more effective substantive procedures should be performed. Choice "c" is incorrect. Inspection of payroll tax returns is an extensive substantive test that would be performed if the control risk were assessed as high.

QUESTION 178
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?

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Questions relating to access controls for assets would not normally be a part of a questionnaire related to controls over the initiation and execution of equipment purchases.
Choice "a" is incorrect. Questions about controls related to the authorization of major repairs would likely be included on a questionnaire related to controls over the initiation and execution of equipment purchases.
Choice "b" is incorrect. Questions about the existence of prenumbered purchase orders would likely be included on the internal control questionnaire since prenumbering functions as an important control supporting the completeness assertion.
Choice "c" is incorrect. Questions about controls related to competitive bids would likely be included on a questionnaire related to controls over the initiation and execution of equipment purchases.

QUESTION 179
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.

Correct Answer: A
Section: Volume D

Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Testing the entity's computation of standard overhead rates generally provides assurance about a client's inventory valuation.
Choice "b" is incorrect. Obtaining confirmation of inventories pledged under loan agreements provides assurance about the appropriate presentation, description, and disclosure of such matters in the financial statements. Choice "c" is incorrect. Reviewing shipping and receiving cutoff procedures for inventories provides assurance about completeness and existence of inventory. Choice "d" is incorrect. Tracing test counts to the entity's inventory listing provides assurance about the completeness of the client's listing.

QUESTION 180
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:

A. Correspond with the investee company to verify the number of shares owned.
B. Inspect the audited financial statements of the investee company.
C. Confirm the number of shares owned that are held by an independent custodian.
D. Determine that the investment is carried at the lower of cost or market.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The auditor would confirm the number of shares held by an independent custodian to establish the existence and ownership of a long-term investment in publicly traded securities.
Choice "a" is incorrect. The investee company may not have timely information regarding the ownership of its stock.
Choice "b" is incorrect. Inspection of the audited financial statements of the investee company does not provide evidence about ownership of the securities.
Choice "d" is incorrect. Determination that the investment is carried at the proper market value provides assurance about valuation and about appropriate presentation and disclosure in the financial statements.

QUESTION 181
Determining that proper amounts of depreciation are expensed provides assurance about management's assertion of:

A. Valuation, allocation, and accuracy.

B. Completeness, accuracy, and occurrence.
C. Rights and obligations, and valuation.
D. Existence, completeness, and accuracy.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Determining that proper amounts of depreciation are expensed provides assurance with regard to valuation and allocation related to the asset, and accuracy in terms of financial statement presentation. Choices "b", "c", and "d" are incorrect. Verifying depreciation computations does not provide evidence with respect to completeness, rights and obligations, existence, or occurrence.

QUESTION 182
In auditing accounts receivable the negative form of confirmation request most likely would be used when:

A. Recipients are likely to return positive confirmation requests without verifying the accuracy of the information.
B. The combined assessed level of inherent and control risk relative to accounts receivable is low.
C. A small number of accounts receivable are involved but a relatively large number of errors are expected.
D. The auditor performs a dual purpose test that assesses control risk and obtains substantive evidence.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Negative confirmations are used when the combined assessed level of inherent and control risk is low, a large number of small balances is involved, and the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.
Choice "a" is incorrect. Blank positive confirmations should be used if the recipient is likely to return a positive confirmation without verifying the accuracy of the information.
Choice "c" is incorrect. If a small number of accounts are involved and a large number of errors are anticipated, positive confirmations should be used. Choice "d" is incorrect. Confirmations are used exclusively as a substantive test, and are not used in the assessment of control risk.

QUESTION 183
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.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. When testing the completeness assertion for accounts payable, the appropriate population would be a list of vendors with whom the entity has previously done business.
Choice "b" is incorrect. Confirming amounts recorded would test the existence assertion, rather than completeness.
Choice "c" is incorrect. Checks drawn in the subsequent period represent only a subset of the client's vendor listing. (It would not include liabilities that have not yet been paid). In obtaining information about the completeness assertion, the auditor is concerned with determining whether liabilities exist which are not reflected in the client's financial statements.
Choice "d" is incorrect. The invoices filed in the entity's open invoice file would provide only a subset of the client's vendor listing. (It would not include liabilities for which the invoice had not yet been received.) In obtaining information about the completeness assertion, the auditor is concerned with determining whether liabilities exist which are not reflected in the client's financial statements.

QUESTION 184
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.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:

Section: Volume D

Choice "b" is correct. The assessment of control risk affects the nature, timing, and extent of substantive audit procedures. If the assessed level of control risk is high, the auditor would generally request that the client schedule the inventory at the end of the year.
Choice "a" is incorrect. If the assessed level of control risk is high, an auditor would probably increase the extent of substantive testing, not the extent of tests of controls.
Choice "c" is incorrect. Client performance of physical counts is an effective internal control, but requesting multiple inventory counts through the year is not an appropriate reaction to the auditor's assessment of control risk as high. The assessment of control risk affects the nature, timing, and extent of substantive audit procedures.
Choice "d" is incorrect. The assessment of control risk affects the nature, timing, and extent of substantive audit procedures. Given the high assessment of control risk, the auditor would prefer more effective substantive procedures; analytical procedures are generally less effective.

QUESTION 185
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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The analytical procedure comparing payroll to standards or budgets is the substantive procedure most likely used for payroll. Choice "a" is incorrect. Unclaimed payroll checks should be returned to an independent individual for follow up.
Choice "b" is incorrect. Individual employee deductions may be difficult to trace directly to journal entries, as companies often make a single journal entry for the sum of individual employee deductions.
Comparing payroll costs to standards or budgets is a more commonly used substantive audit procedure.
Choice "c" is incorrect. Observing payroll distribution is an effective procedure to detect payments to fictitious employees, but with the advent of electronic payroll distribution, it is not as likely to be performed as comparing payroll costs to standards or budgets.

QUESTION 186
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 bondholders at year-end.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Comparing interest expense with the bond payable amount for reasonableness provides evidence that all interest expense was included and that the outstanding balance of the bonds payable is reasonable, as well as providing limited evidence concerning the amortization of bond discounts or premiums.
Choice "a" is incorrect. The auditor would recalculate bond premiums and discounts, rather than use an analytical procedure.
Choice "b" is incorrect. The auditor would normally examine documentation of the bond instruments rather than of assets purchased to determine the existence of any liens on the assets. Choice "d" is incorrect. The auditor would confirm the outstanding bonds payable balance, not the existence of individual bondholders.

QUESTION 187
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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. In auditing the granting of stock options, the auditor would normally trace the transactions to approval by the board of directors.
Choice "a" is incorrect. The Secretary of State would not be able to confirm the granting of stock options.
Choice "b" is incorrect. Verifying the existence of option holders provides little evidence to support management's financial statement assertions. Choice "c" is

incorrect. Converted stock options may be distributed from authorized common shares rather than treasury stock.

QUESTION 188
An auditor analyzes repairs and maintenance accounts primarily to obtain evidence in support of the audit assertion that all:

A. Noncapitalizable expenditures for repairs and maintenance have been recorded in the proper period.
B. Expenditures for property and equipment have been recorded in the proper period.
C. Noncapitalizable expenditures for repairs and maintenance have been properly charged to expense.
D. Expenditures for property and equipment have not been charged to expense.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Analysis of repairs and maintenance expense provides assurance with regard to management's assertion that expenditures for property and equipment have been capitalized and have not been charged to expense. Choice "a" is incorrect. Analysis of repairs and maintenance accounts provides limited evidence about the appropriate cutoff of transactions for the period.
Choice "b" is incorrect. Analysis of repairs and maintenance accounts does not provide evidence about the appropriate cutoff of expenditures for property and equipment. Choice "c" is incorrect. Analysis of capitalized expenditures might help identify noncapitalizable expenditures, which were capitalized erroneously.

QUESTION 189
Which of the following internal 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.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The use of time tickets to record actual labor worked on production orders is the best way to prevent direct labor from being charged to manufacturing overhead. Choice "a" is incorrect. The work-in-process inventory contains not only labor, but also materials and overhead.
Choice "b" is incorrect. Daily journal entries are made to record the use of labor and materials.
Reconciliation of the amount of daily labor to approved production orders would not prevent direct labor from being charged to manufacturing overhead. Choice "d" is incorrect. The work-in-process inventory contains not only labor, but also materials and overhead.

QUESTION 190
Which of the following internal 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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. In order to maintain accurate perpetual inventory records, periodic inventory counts should be used to adjust perpetual records.
Choice "a" is incorrect. By comparing perpetual inventory records to current costs, the company ensures that the inventory is appropriately valued at the lower of cost or market, but the accuracy of the perpetual inventory is not assured.
Choice "b" is incorrect. While a just-in-time inventory system will usually reduce the amount of inventory on hand, it does not necessarily improve the accuracy of inventory records.
Choice "c" is incorrect. The matching of requisitions, receiving reports, and purchase orders is a control to ensure that purchases of inventory are properly authorized, but it does not necessarily improve the accuracy of inventory records.

QUESTION 191
When an entity uses a trust company as custodian of its marketable securities, the possibility of concealing fraud most likely would be reduced if the:

A. Trust company has no direct contact with the entity employees responsible for maintaining investment accounting records.
B. Securities are registered in the name of the trust company, rather than the entity itself.
C. Interest and dividend checks are mailed directly to an entity employee who is authorized to sell securities.
D. Trust company places the securities in a bank safe-deposit vault under the custodian's exclusive control.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. When an entity uses a trust company as custodian of its marketable securities, the possibility of concealing fraud would be reduced if the trust company deals only with the person reconciling the accounts, and not with the employees responsible for maintaining investment records.
Choice "b" is incorrect. The securities should be in the entity's name, and not the trust company's.
Choice "c" is incorrect. If interest and dividend checks are mailed directly (custody of the asset) to the employee authorized to sell the securities (authorization), incompatible duties would result which may result in fraud being concealed. Choice "d" is incorrect. Limiting access to the assets would reduce the possibility of theft, but would not reduce the possibility of concealing fraud.

QUESTION 192
Which of the following circumstances most likely would cause an auditor to believe that material misstatements may exist in an entity's financial statements?

A. Accounts receivable confirmation requests yield significantly fewer responses than expected.
B. Audit trails of computer-generated transactions exist only for a short time.
C. The chief financial officer does not sign the management representation letter until the date of the auditor's report.
D. Management consults with other accountants about significant accounting matters.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Confirmation of accounts receivable confirm the existence of the receivable. A lower than expected response rate could be indicative of fictitious customer accounts. Choice "b" is incorrect. In a computerized accounting environment, audit trails generally exist for only a short time.
Choice "c" is incorrect. The management representation letter should be signed and dated on the date of the auditor's report.
Choice "d" is incorrect. Consultation with other accountants would not cause an auditor to believe material misstatements have occurred.

QUESTION 193
Which of the following procedures would an auditor most likely perform to obtain assurance that slow moving and obsolete items included in inventories are properly identified?

A. Testing shipping and receiving cutoff procedures.
B. Confirming inventories at locations outside the entity's premises.
C. Examining an analysis of inventory turnover.
D. Tracing inventory observation test counts to perpetual listings.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Examining an analysis of inventory turnover helps identify slow-moving, excess, defective, and obsolete items included in inventories. In order for inventory to be properly valued, these items may need to be written down.
Choice "a" is incorrect. Testing shipping and receiving cutoff provides evidence regarding completeness of inventory and rights and obligations related to inventory, but it does not provide evidence regarding the identification and valuation of slow-moving and obsolete items.
Choice "b" is incorrect. Confirming inventories at locations outside the entity's premises provides evidence regarding existence and completeness of inventory, but it does not provide evidence regarding the identification and valuation of slow-moving and obsolete items.
Choice "d" is incorrect. Tracing inventory observation test counts to perpetual listings provides evidence regarding the completeness of inventory, but it does not provide evidence regarding the identification and valuation of slow-moving and obsolete items.

QUESTION 194
An auditor scans a client's investment records for the period just before and just after the year-end to determine that any transfers between categories of investments have been properly recorded. The primary purpose of this procedure is to obtain evidence about management's financial statement assertions of:

A. Rights and obligations, and existence.
B. Valuation and accuracy, and rights and obligations.
C. Existence, and understandability and classification.
D. Understandability and classification, and valuation and accuracy.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Investments may be classified as trading, available-for-sale, or held-to-maturity. The classification of each investment into one of these three categories determines how it will be shown on the balance sheet (understandability and classification) and whether it will be valued at market or at amortized cost (valuation and accuracy).
Choices "a", "b", and "c" are incorrect. Reviewing transfers of investments between categories will not provide evidence regarding rights and obligations or existence. Rights and obligations and existence would be concerned with whether the securities actually exist and are owned by the client.

QUESTION 195
Which of the following procedures represents a weakness in internal controls for payroll?

A. The payroll clerk distributes signed payroll checks. Undistributed checks are returned to the payroll department.
B. The accounting department wires transfers funds to the payroll bank account. The transfer is based on totals from the payroll department summary.
C. The payroll department prepares checks using a signature plate. The treasurer supervises the process before payroll checks are distributed.
D. The payroll department prepares checks. The chief financial officer signs the payroll checks.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Unclaimed payroll checks should be returned to an independent party for follow up. Returning such checks (assets) to the payroll department (recordkeeping) represents an inadequate segregation of duties.
Choice "b" is incorrect. It is acceptable for the accounting department to set up the transfer of funds into the payroll account, since the accounting department does not have access to the actual funds.
Choice "c" is incorrect. The treasurer's supervision is crucial in this choice, serving to separate the recordkeeping function (payroll department) from the custodial function (the treasurer).
Choice "d" is incorrect. It is an appropriate segregation of duties for the payroll department to prepare the checks, while the chief financial officer signs them. This separates the recordkeeping function from the custodial function.

QUESTION 196
In auditing a manufacturing entity, which of the following procedures would an auditor least likely perform to determine whether slow-moving, defective, and obsolete items included in inventory are properly identified?

A. Test the computation of standard overhead rates.
B. Tour the manufacturing plant or production facility.
C. Compare inventory balances to anticipated sales volume.
D. Review inventory experience and trends.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Testing the computation of standard overhead rates relates to the accumulation of costs during the manufacturing process, and not to whether the inventory is slow-moving, defective, or obsolete after manufacture.
Choice "b" is incorrect. During a tour of the manufacturing plant or production facility, the auditor should be alert for items that appear to be old, obsolete, or defective.
Choice "c" is incorrect. Comparisons of inventory balances with anticipated sales volume might indicate higher inventory levels than would be expected, perhaps due to slow-moving, defective, or obsolete inventory items.
Choice "d" is incorrect. Review of inventory experience and trends may indicate slow-moving, defective, or obsolete inventory items. For example, the auditor may notice a particular item that is building up in inventory, or a trend toward reduced sales of that item.

QUESTION 197
When a company's stock record books are maintained by an outside registrar or transfer agent, the auditor should obtain confirmation from the registrar or transfer agent concerning the:

A. Amount of dividends paid to related parties.
B. Expected proceeds from stock subscriptions receivable.
C. Number of shares issued and outstanding.
D. Proper authorization of stock rights and warrants.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. If a client uses a stock transfer agent, confirmations should be used to provide evidence of shares authorized, issued, and outstanding, as well as to provide evidence of the individual transactions.
Choice "a" is incorrect. It is the auditor's responsibility to identify, examine, and evaluate the disclosure of related party transactions. The stock transfer agent would not necessarily know which parties are related to the client.
Choice "b" is incorrect. The auditor should recalculate, or should review management's calculations of, stock subscriptions receivable. Confirmation from the

stock transfer agent would not be necessary to review this information. Choice "d" is incorrect. Proper authorization of stock rights and warrants would best be verified by reviewing the minutes of Board of Director meetings. Confirmation from the stock transfer agent would not be necessary to review this information.

QUESTION 198
When a client engages in transactions involving derivatives, the auditor should:

A. Develop an understanding of the economic substance of each derivative.
B. Confirm with the client's broker whether the derivatives are for trading purposes.
C. Notify those charged with governance about the risks involved in derivative transactions.
D. Add an explanatory paragraph to the auditor's report describing the risks associated with each derivative.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. In auditing investments in securities and derivatives, the auditor must assess the reasonableness and appropriateness of assumptions, market variables, and valuation models. In order to do this, the auditor must consider whether the substance of transactions or events differs materially from their form. Remember that generally accepted accounting principles require transactions and events to be reported in accordance with their economic substance, even if this differs from their form.
Choice "b" is incorrect. While the auditor might confirm settled and unsettled transactions with the broker, whether a security is held for trading purposes is based on management intent and would not be confirmed with the broker. Choice "c" is incorrect. There is no requirement that the auditor notify those charged with governance about the risks involved in derivative transactions.
Choice "d" is incorrect. There is no requirement that the auditor add an explanatory paragraph to the auditor's report describing the risks associated with each derivative.

QUESTION 199
An auditor usually determines whether dividend income from publicly-held investments is reasonable by computing the amounts that should have been received by referring to:

A. Stock ledgers maintained by independent registrars.
B. Dividend records on file with the SEC.
C. Records produced by investment services.
D. Minutes of the investee's board of directors.

Correct Answer: C

Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Investment income from dividends is generally recalculated by comparing recorded income with dividend record books produced by investment advisory services such as "Moody's Dividend Record." These books state the dividend that was declared and paid by the investee.
Choice "a" is incorrect. Stock ledgers maintained by independent registrars indicate how many shares of stock are issued and outstanding, and identify the shareholders of record, but they do not contain information concerning dividends.
Choice "b" is incorrect. Dividend records on file with the SEC would probably include appropriate information, but it is more efficient to use a single source (such as "Moody's") than it is to obtain and review SEC records for each investee. Choice "d" is incorrect. Annual audited financial statements of the investee companies give the total dividends paid, but there may not be enough information to determine exactly how much went to each type of stock and hence to each stockholder. In addition, it is more efficient to use a single source (such as "Moody's") than it is to obtain and review the financial statements of each investee.

QUESTION 200
An auditor's inquiries of management disclosed that the entity recently invested in a series of energy derivatives to hedge against the risks associated with fluctuating oil prices. Under these circumstances, the auditor should:

A. Perform analytical procedures to determine if the derivatives are properly valued.
B. Examine the contracts for possible risk exposure and the need to recognize losses.
C. Confirm the marketability of the derivatives with a commodity specialist.
D. Document the derivatives in the auditor's communication with those charged with governance.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Generally accepted accounting principles specify that, in order to qualify for hedge treatment, the entity must demonstrate and disclose a number of transaction features including risk exposure. The auditor would therefore need to examine the contracts to evaluate the character of the hedge and the degree to which losses should be recognized in the determination of income, as well as the character of any disclosures.
Choice "a" is incorrect. Generally accepted accounting principles require this derivative to be valued at fair value. While the auditor does need to test management's assertions about fair value, analytical procedures are not the most likely way to do this. More likely, the auditor would obtain quoted market prices from financial publications, the exchanges, the National Association of Securities Dealers Automated Quotations System (NASDAQ), or pricing services. If quoted market prices were not available, estimates based on valuation models would be used.

Choice "c" is incorrect. The auditor would not generally confirm marketability with a commodity specialist, but rather would test the valuation of such securities by reference to quoted market prices, by using pricing services, or based on a valuation model.
Choice "d" is incorrect. There is no requirement that investments in derivatives be communicated to those charged with governance.

QUESTION 201
An auditor's principal objective in analyzing repairs and maintenance expense accounts is to:

A. Determine that all obsolete plant and equipment assets were written off before the year-end.
B. Verify that all recorded plant and equipment assets actually exist.
C. Discover expenditures that were expensed but should have been capitalized.
D. Identify plant and equipment assets that cannot be repaired and should be written off.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The auditor reviews repair and maintenance expense accounts to test for completeness of asset additions (i.e., the auditor is looking for items recorded as repairs or maintenance that would more properly have been capitalized as betterment of an asset).
Choice "a" is incorrect. Analyzing the repairs and maintenance account does not provide evidence about obsolete assets. The auditor might review asset records for old assets, or observe assets that are not being used, in an effort to determine whether obsolete plant and equipment assets were written off before year-end.
Choice "b" is incorrect. Analyzing the repairs and maintenance account does not provide evidence about the existence of assets. The auditor might select recorded plant and equipment assets, and then physically locate and observe them, in order to verify existence.
Choice "d" is incorrect. Analyzing the repairs and maintenance account does not provide evidence about assets that cannot be repaired. The auditor might review asset records for old assets, or observe assets that are not being used, in an effort to determine whether assets that cannot be repaired have been properly written off.

QUESTION 202
The auditor's inventory observation test counts are traced to the client's inventory listing to test for which of the following financial statement assertions?

A. Completeness.
B. Rights and obligations.
C. Allocation and valuation.
D. Understandability and classification.

Correct Answer: A

Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The auditor should test the physical inventory report by tracing test counts taken by the auditor to the report, thereby verifying its completeness.
Choice "b" is incorrect. Tracing from test counts to the client's inventory listing does not test rights and obligations. Rights and obligations might be tested by examining paid vendors' invoices, inspecting consignment agreements and contracts, or by confirming inventory held at outside locations.
Choice "c" is incorrect. Tracing from test counts to the client's inventory listing does not test allocation and valuation. Allocation and valuation might be tested by examining paid vendors' invoices, evaluating direct labor rates, recalculating overhead rates, or examining an analysis of inventory turnover.
Choice "d" is incorrect. Tracing from test counts to the client's inventory listing does not test understandability and classification. Understandability and classification might be tested by confirming inventories pledged under loan agreements, examining drafts of the financial statements for appropriate balance sheet classification, etc.

QUESTION 203
An analysis of which of the following accounts would best aid in verifying that all fixed assets have been capitalized?

A. Cash.
B. Depreciation expense.
C. Property tax expense.
D. Repairs and maintenance.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. An analysis of the repairs and maintenance account would best aid the auditor in verifying that all fixed assets have been capitalized. This account is generally analyzed to test for completeness of asset additions (i.e., the auditor is looking for items recorded as repairs or maintenance that would more properly have been capitalized as betterment of an asset).
Choice "a" is incorrect. An analysis of cash would not identify fixed assets that were not properly capitalized, since cash would be paid for the purchase regardless of whether the item were expensed or capitalized.
Choice "b" is incorrect. An analysis of depreciation expense would not identify fixed assets that were not properly capitalized, since no depreciation would be included for items not already classified as assets. Choice "c" is incorrect. An analysis of property tax expense would not identify fixed assets that were not

properly capitalized, since no property tax would be included for items not already classified as assets.

QUESTION 204
Which of the following strategies most likely could improve the response rate of the confirmations of accounts receivable?

A. Restrict the selection of accounts to be confirmed to those customers with large balances.
B. Include a list of items or invoices that constitute the customers' account balances.
C. Explain to customers that discrepancies will be investigated by an independent third party.
D. Ask customers to respond to the confirmation requests directly to the auditor by fax.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. The auditor should consider the types of information respondents will be readily able to confirm. For instance, some accounting systems facilitate the confirmation of single transactions rather than entire balances. In such cases, the auditor might consider including a client-prepared statement of account showing details of the customer's account balance being confirmed. By making it easier for customers to determine which items are included in the balance being confirmed, the auditor also makes it more likely that those customers will respond.
Choice "a" is incorrect. Restricting the selection of accounts to be confirmed to those customers with large balances doesn't improve response rates, as customers with large balances are not necessarily more likely to respond than customers with small balances.
Choice "c" is incorrect. Explaining to customers that discrepancies will be investigated by an independent third party would not necessarily encourage them to respond, as they might be reluctant to set off this investigation.
Choice "d" is incorrect. Responses received by fax should be verified by calling the senders and requesting that the original confirmations be mailed back. Asking customers to respond by fax might actually reduce the response rate for receiving the original confirmation, since customers may decide that since they already sent the fax, they don't need to send the original back as well.

QUESTION 205
In establishing the existence and ownership of long-term investments in the form of publicly-traded stock, an auditor most likely would inspect the securities or:

A. Correspond with the investee company to verify the number of shares owned.
B. Confirm the number of shares owned that are held by an independent custodian.
C. Apply analytical procedures to the dividend income and investments accounts.
D. Inspect the cash receipts journal for amounts that could represent the sale of securities.

Correct Answer: B

Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Confirmations should be requested from the custodian for securities that are in the possession of third parties.
Choice "a" is incorrect. The investee company may not have timely information regarding the ownership of its stock, nor would an investee typically want to correspond with all of its shareholders in this manner.
Choice "c" is incorrect. Analytical procedures might be used to test the reasonableness of dividend income, but this would not provide evidence about the existence and ownership of the investments.
Choice "d" is incorrect. Inspecting the cash receipts journal for amounts that could represent the sale of securities might provide evidence regarding sales (and gains or losses on sales), but would not provide evidence about the existence and ownership of the investments.

QUESTION 206
Which of the following best describes the auditor's responsibility with respect to fair values?

A. The auditor should determine whether management has the intent and ability to carry out courses of action that may affect fair values.
B. The auditor should assess the risk of material misstatement of fair value measurements.
C. The auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP.
D. The auditor should make fair value measurements and disclosures in accordance with GAAP and should identify and support any significant assumptions used.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The auditor's overall responsibility is to obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP.
Choice "a" is incorrect. While it is true that the auditor should determine whether management has the intent and ability to carry out courses of action that may affect fair values, this is just one part of evaluating fair value measurements and not the best description of the auditor's overall responsibility.
Choice "b" is incorrect. While it is true that the auditor should assess the risk of material misstatement of fair value measurements, this is done to determine the nature, timing, and extent of audit procedures. It is not the best representation of the auditor's overall responsibility.
Choice "d" is incorrect. Management (and not the auditor) should make fair value measurements and disclosures in accordance with GAAP and should identify

and support any significant assumptions used.

QUESTION 207
Which of the following would an auditor least likely consider with respect to fair values?

A. Segregation of duties between those committing the entity to certain transactions and those responsible for undertaking the valuations related to those transactions.
B. The effect on fair value measurement and disclosures of information available subsequent to the audit.
C. The role of information technology in determining fair value measurements and disclosures.
D. Whether the valuation methods used are appropriate in relation to the industry in which the entity operates.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. The auditor would consider subsequent events and transactions occurring before the completion of the audit, not after. The auditor is not responsible for predicting the future, and would not be expected to evaluate the effect of conditions arising subsequent to the audit, that, if known at the time of the audit, might have affected fair value measurements and disclosures.
Choice "a" is incorrect. The auditor is responsible for understanding relevant controls. Segregation of duties between those committing the entity to certain transactions and those responsible for undertaking the valuations related to those transactions is a relevant control.
Choice "c" is incorrect. The auditor is responsible for understanding the entity's process for determining fair value measurements and disclosures. Considering the role of information technology in determining fair value measurements and disclosures is part of understanding this process.
Choice "d" is incorrect. The auditor should evaluate whether the valuation model is appropriate given the entity's circumstances. As part of this evaluation, the auditor should consider whether the valuation method is appropriate in relation to the business, industry, and environment in which the entity operates.

QUESTION 208
Which of the following procedures most likely would assist an auditor in determining whether management has identified all accounting estimates that could be material to the financial statements?

A. Inquire about the existence of related party transactions.
B. Determine whether accounting estimates deviate from historical patterns.
C. Confirm inventories at locations outside the entity.
D. Review the lawyer's letter for information about litigation.

Correct Answer: D

Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The auditor should inquire of management concerning pending or threatened litigation, and should obtain a letter from the client's lawyer to corroborate this information. Included in this letter is either an identification of the omission of any pending or threatened litigation, claims, and assessments, or a statement that the list of such matters (as provided by management) is complete. Choice "a" is incorrect. Accounting estimates generally are not associated with the existence of related party transactions.
Choice "b" is incorrect. Evaluating deviations from historical patterns assists an auditor in determining if a recorded estimate is reasonable, but it does not provide assurance that management has identified all material accounting estimates. Choice "c" is incorrect. Accounting estimates generally are not associated with the existence of inventories at locations outside the entity.

QUESTION 209
In evaluating the reasonableness of an entity's accounting estimates, an auditor normally would be concerned about assumptions that are:

A. Susceptible to bias.
B. Consistent with prior periods.
C. Insensitive to variations.
D. Similar to industry guidelines.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. An auditor would be concerned about assumptions that are susceptible to bias because it is more likely that estimates based on such assumptions will be misstated.
Choice "b" is incorrect. The auditor would not normally be concerned about assumptions that are consistent with prior periods, as estimates based on such assumptions are less likely to be misstated.
Choice "c" is incorrect. The auditor would not normally be concerned about assumptions that are insensitive to variation, as estimates based on such assumptions are less likely to be misstated.
Choice "d" is incorrect. The auditor would not normally be concerned about assumptions that are similar to industry guidelines, as estimates based on such assumptions are less likely to be misstated.

QUESTION 210
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 in internal control.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. A lawyer's refusal to furnish the information requested in an inquiry letter would be a limitation on the scope of the audit sufficient to preclude an unqualified opinion.
Choice "a" is incorrect. An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles. A lawyer's refusal to furnish the information requested in an inquiry letter does not necessarily mean that the financial statements are not fairly presented in conformity with GAAP.
Choice "c" is incorrect. A lawyer's refusal to furnish the information requested in an inquiry letter is not a reason to withdraw from the engagement, as long as the lawyer's refusal is not based on the client's request. Choice "d" is incorrect. A lawyer's refusal to furnish the information requested in an inquiry letter is not considered to be a significant deficiency in internal control.

QUESTION 211
A client's lawyer is unable to form a conclusion about the likelihood of an unfavorable outcome of pending litigation because of inherent uncertainties. If the litigation's effect on the client's financial statements could be material but it is properly disclosed in the financial statements, the auditor most likely would:

A. Issue a qualified opinion in the auditor's report because of the lawyer's scope limitation.
B. Withdraw from the engagement because of the lack of information furnished by the lawyer.
C. Disclaim an opinion on the financial statements because of the materiality of the litigation's effect.
D. Issue an unqualified opinion without modification.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Even if the effect of the matter on the financial statements could be material, if it is properly disclosed (and supported by available evidence), the auditor will ordinarily issue an unqualified opinion without any modification.
Choice "a" is incorrect. The inability to form an opinion on the amount or range of potential loss would generally not be classified as a scope limitation resulting in a qualification.
Choice "b" is incorrect. The auditor should consider withdrawing from the engagement only if the lawyer withholds information per the client's request. Given the fact pattern, there is no need for the auditor to withdraw from the engagement. Choice "c" is incorrect. The inability to form an opinion on the amount or range of potential loss would generally not be classified as a scope limitation resulting in a disclaimer of opinion.

QUESTION 212
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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure.
Choice "a" is incorrect. Since related party transactions are (by definition) not considered to be at arm's length, the auditor generally does not ascertain the rights and obligations of the related parties.
Choice "b" is incorrect. The auditor generally does not confirm the existence of the related parties.
Choice "c" is incorrect. Since related party transactions are (by definition) not considered to be at arm's length, the auditor generally does not verify the valuation of the related party transactions.

QUESTION 213
Which of the following procedures would an auditor ordinarily perform first in evaluating management's accounting estimates for reasonableness?

A. Develop independent expectations of management's estimates.
B. Consider the appropriateness of the key factors or assumptions used in preparing the estimates.
C. Test the calculations used by management in developing the estimates.
D. Obtain an understanding of how management developed its estimates.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. In evaluating the reasonableness of an accounting estimate, the auditor should first obtain an understanding of how management developed its estimate.
Choice "a" is incorrect. After first obtaining an understanding of how management developed its estimate, the auditor should use one or a combination of the following approaches: a) review and test the process used by management to develop the estimate, b) develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate, or c) review subsequent events.
Choice "b" is incorrect. After having first obtained an understanding of how management developed its estimate, the auditor should consider testing management's process by assessing the appropriateness of the key factors or assumptions used in preparing the estimate.
Choice "c" is incorrect. After first obtaining an understanding of how management developed its estimate, the auditor should use one or a combination of the following approaches: a) review and test the process used by management to develop the estimate, b) develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate, or c) review subsequent events.

QUESTION 214
In evaluating the reasonableness of an accounting estimate, an auditor most likely would concentrate on key factors and assumptions that are:

A. Consistent with prior periods.
B. Similar to industry guidelines.
C. Objective and not susceptible to bias.
D. Deviations from historical patterns.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. In evaluating the reasonableness of an estimate, an auditor would normally concentrate on key factors and assumptions that are (1) significant to the accounting estimate, (2) sensitive to variations, (3) deviations from historical patterns, or (4) subjective and susceptible to misstatements and bias.
Choice "a" is incorrect. The auditor need not concentrate on key factors or assumptions that are consistent with those of prior periods, since estimates based on such assumptions are less likely to be misstated.
Choice "b" is incorrect. The auditor need not concentrate on key factors or assumptions that are similar to industry guidelines, since estimates based on such assumptions are less likely to be misstated. Choice "c" is incorrect. The auditor need not focus on factors that are objective and not susceptible to bias, since estimates based on such assumptions are less likely to be misstated.

QUESTION 215
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.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. A letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.
Choice "a" is incorrect. While the attorney is requested to provide the auditor with the likelihood of an unfavorable outcome, the primary source of this information is management.
Choice "c" is incorrect. The attorney's opinion of historical experiences may provide some information to the auditor, but it is not the primary goal of audit inquiry letters.
Choice "d" is incorrect. While the attorney is asked to comment on management's description and evaluation of litigation, claims, and assessments that existed at the balance sheet date, the primary source of this information is management.

QUESTION 216
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.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. After identifying the occurrence of a related party transaction, the auditor should apply the procedures considered necessary to obtain satisfaction concerning the purpose and nature of the transaction and its effect on the financial statements.
Choice "a" is incorrect. While an extra paragraph may be added to emphasize a matter, there is no requirement that related party transactions be disclosed via explanatory language added to the auditor's report.
Choice "b" is incorrect. Analytical procedures are generally not effective in the identification of related party transactions.
Choice "d" is incorrect. It will generally not be possible to substantiate representations that the transaction was consummated on terms equivalent to those that would have prevailed in an arm's-length transaction.

QUESTION 217
Which of the following auditing procedures most likely would assist an auditor in identifying related party transactions?

A. Retesting ineffective internal controls previously reported to those charged with governance.
B. Sending second requests for unanswered positive confirmations of accounts receivable.
C. Reviewing accounting records for nonrecurring transactions recognized near the balance sheet date.
D. Inspecting communications with law firms for evidence of unreported contingent liabilities.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Unusual nonrecurring transactions near year-end are characteristic of related party transactions. Since related party transactions are not at arm's-length, management may use such transactions to bolster sales or assets.
Choice "a" is incorrect. Retesting ineffective controls would not assist the auditor in identifying related party transactions.
Choice "b" is incorrect. Confirmation of accounts receivable would not assist the auditor in identifying related party transactions.

Choice "d" is incorrect. Finding unrecorded contingent liabilities would not assist the auditor in identifying related party transactions.

QUESTION 218
Which of the following factors most likely would cause a CPA not to accept a new audit engagement?

A. The prospective client's unwillingness to permit inquiry of its legal counsel.
B. The inability to review the predecessor auditor's working papers.
C. The CPA's lack of understanding of the prospective client's operations and industry.
D. The indications that management has not investigated employees in key positions before hiring them.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. A direct letter of inquiry to the entity's legal counsel is required, and a client's refusal to permit such inquiry generally will result in a disclaimer of opinion. It is unlikely that a CPA would accept a new audit engagement under such circumstances.
Choice "b" is incorrect. Inability to review the predecessor auditor's working papers would not cause a CPA to decline a new audit engagement. The CPA would simply need to perform an appropriate level of work to substantiate the opening financial statement balances.
Choice "c" is incorrect. The CPA need not have an understanding of the prospective client's operations and industry before accepting a new audit engagement. Such an understanding may be obtained after acceptance, during the planning phase of the engagement.
Choice "d" is incorrect. Indications that management has not investigated employees in key positions before hiring them is a fraud risk factor that the auditor would need to consider in planning the audit, but it would not cause the CPA to decline the engagement.

QUESTION 219
Which of the following procedures most likely could assist an auditor in identifying related party transactions?

A. Performing tests of controls concerning the segregation of duties.
B. Evaluating the reasonableness of management's accounting estimates.
C. Reviewing confirmations of compensating balance arrangements.
D. Scanning the accounting records for recurring transactions.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Compensating balance arrangements may be maintained by or for related parties.
Choice "a" is incorrect. Performing tests of controls concerning the segregation of duties relates to the allocation of responsibilities among company employees; related party transactions typically relate to transactions with affiliates, owners, or management.
Choice "b" is incorrect. Evaluating the reasonableness of management's accounting estimates would not provide any evidence of transactions with affiliates, owners, or management. Choice "d" is incorrect. Related party transactions are more likely to be nonrecurring than recurring.

QUESTION 220
"In connection with an audit of our financial statements, management has prepared, and furnished to our auditors a description and evaluation of certain contingencies." The foregoing passage most likely is from a(an):

A. Audit inquiry letter to legal counsel.
B. Management representation letter.
C. Audit committee's communication to the auditor.
D. Financial statement footnote disclosure.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Legal counsel is best able to corroborate the description and evaluation of contingencies provided by management.
Choice "b" is incorrect. The management representation letter serves to confirm, in writing, representations provided to the auditor. It does not include a statement indicating that management has prepared and furnished a list of contingencies.
Choice "c" is incorrect. The audit committee would not communicate to the auditor regarding the list of contingencies prepared by management.
Choice "d" is incorrect. It would be inappropriate to indicate in the footnotes whether specific information was provided by management to the auditor.

QUESTION 221
Which of the following procedures would an auditor ordinarily perform first in evaluating the reasonableness of management's accounting estimates?

A. Review transactions occurring prior to the completion of field work that indicate variations from expectations.
B. Compare independent expectations with recorded estimates to assess management's process.
C. Obtain an understanding of how management developed its estimates.

D. Analyze historical data used in developing assumptions to determine whether the process is consistent.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. In evaluating the reasonableness of an estimate, the auditor must first obtain an understanding of how management developed its estimate.
Choices "a", "b", and "d" are incorrect. After obtaining an understanding of how management developed its estimate, the auditor would perform one or a combination of the following procedures:
1. Review subsequent events and transactions (occurring prior to completion of fieldwork) thatcorroborate the value of the estimate (choice "a").
2. Develop an independent estimate of the item for comparative purposes (choice "b").
3. Review and test the procedures used by management to develop the estimate (choice "d").

QUESTION 222
Which of the following parties should request inquiry of a client's lawyer?

A. The auditor.
B. The stockholders.
C. Client management.
D. The auditor's attorney.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The letter of inquiry to the client's attorneys is a request made by client management. Due to attorney-client privilege, the attorney would not be able to respond to such a request made by any other party. Note that management would request the attorney to respond directly to the auditor.
Choice "a" is incorrect. The auditor may request that the client include certain matters in the letter, but technically speaking, the request itself comes from client management.
Choice "b" is incorrect. The stockholders would not have any involvement in the letter of audit inquiry.
Choice "d" is incorrect. The auditor's attorney would not have any involvement in the letter of audit inquiry related to specific client engagements.

QUESTION 223
If a client will not permit inquiry of outside legal counsel, the auditor's report ordinarily will contain a(an):

A. Adverse opinion.
B. Disclaimer of opinion.
C. Unqualified opinion with a separate explanatory paragraph.
D. Qualified opinion.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. A client's refusal to permit inquiry of outside legal counsel is a significant scope limitation that generally will result in a disclaimer of opinion.
Choice "a" is incorrect. Adverse opinions are used when there are very material departures from GAAP, which is not the case here.
Choice "c" is incorrect. A client's refusal to permit inquiry of outside legal counsel is a significant scope limitation that generally will result in a disclaimer of opinion. An unqualified opinion with a separate explanatory paragraph would not be sufficient to address this situation.
Choice "d" is incorrect. A client's refusal to permit inquiry of outside legal counsel is a significant scope limitation that generally will result in a disclaimer of opinion. A qualified opinion would not be sufficient to address this situation.

QUESTION 224
The accounts receivable turnover ratio increased significantly over a two-year period. This trend could indicate that:

A. The accounts receivable aging has deteriorated.
B. The company has eliminated its discount policy.
C. The company is more aggressively collecting customer accounts.
D. Customer sales have substantially decreased.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The accounts receivable turnover ratio is calculated as sales / receivables. More aggressive collection policies will result in a decrease in the receivables balance, which in turn causes the turnover ratio to increase.
Choice "a" is incorrect. A deterioration in the aging of receivables implies a greater receivables balance, which would cause the turnover ratio to decline.
Choice "b" is incorrect. Elimination of the company's discount policy would increase both the sales figure and the receivables balance. The net effect on the turnover ratio would depend upon the proportionate impact of each increase. Choice "d" is incorrect. A decline in sales would cause a decrease in both sales and receivables. The net effect on the turnover ratio would depend upon the proportionate impact of each decrease.

QUESTION 225
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 plaintiff will have problems establishing any liability."
B. "I believe that this action has only a remote chance in establishing any liability."
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."

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The lawyer's comment that the plaintiff "will have problems establishing any liability" is vague...it does not provide an evaluation of the likelihood of an unfavorable outcome. Does "will have problems" mean a loss is probable, reasonably possible, or remote? The auditor would likely want to request clarification to ensure that the situation has been properly accounted for and disclosed.
Choice "b" is incorrect. When a lawyer asserts that a contingent liability is improbable ("remote chance"), it is unlikely that the auditor would require further clarification.
Choice "c" is incorrect. When a lawyer asserts that a contingent liability is improbable ("without merit"), it is unlikely that the auditor would require further clarification.
Choice "d" is incorrect. When a lawyer asserts that a contingent liability is improbable ("able to defend this action successfully"), it is unlikely that the auditor would require further clarification.

QUESTION 226
Which of the following events most likely would indicate the existence of related parties?

A. Granting stock options to key executives at favorable prices.
B. High turnover of senior management and members of the board of directors.

C. Failure to correct internal control weaknesses on a timely basis.
D. Selling real estate at a price significantly different from appraised value.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Transactions based on terms that are significantly different from those that would be expected in an arm's length transaction, such as selling real estate at a price significantly different from appraised value, may be indicative of related party involvement.
Choice "a" is incorrect. Executives are considered to be related parties regardless of whether or not stock options at favorable prices are granted.
Choice "b" is incorrect. High turnover of management and/or board members may be caused by any number of circumstances, but is unlikely to be related to the existence of related parties. Choice "c" is incorrect. Failure to correct internal control weaknesses on a timely basis is a management decision that is unlikely to be related to the existence of related parties.

QUESTION 227
In evaluating an entity's accounting estimates, one of the auditor's objectives is to determine whether the estimates are:

A. Prepared in a satisfactory control environment.
B. Consistent with industry guidelines.
C. Based on verifiable objective assumptions.
D. Reasonable in the circumstances.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The auditor has four responsibilities with respect to evaluating estimates: to assess management's practices, to verify that all material estimates have been developed, to determine that accounting estimates are reasonable, and to ensure that accounting estimates are properly recorded and disclosed.
Choice "a" is incorrect. With respect to accounting estimates, the auditor would only be concerned with the entity's control environment in terms of assessing management's policies and practices. It might be the case that the control environment is less than satisfactory, but as long as management has taken this into

account, and has properly developed, presented, and disclosed all material estimates, the poor control environment is irrelevant.
Choice "b" is incorrect. The auditor is concerned with making sure that management has properly developed, presented, and disclosed all material estimates. Whether or not those estimates are consistent with industry guidelines is not a concern, as long as the estimates are reasonable in the circumstances.
Choice "c" is incorrect. Estimates need not be based on verifiable objective assumptions. In fact, many estimates are subjective, and can be susceptible to misstatement. The auditor should evaluate whether management has properly developed, presented, and disclosed all material estimates.

QUESTION 228
Which of the following factors most likely would cause a CPA to decline to accept a new audit engagement?

A. The CPA does not understand the entity's operations and industry.
B. Management acknowledges that the entity has had recurring operating losses.
C. The CPA is unable to review the predecessor auditor's working papers.
D. Management is unwilling to permit inquiry of its legal counsel.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. If a prospective client is unwilling to permit inquiry of its legal counsel, the CPA must consider the implications of this refusal. Such refusal may indicate a lack of cooperativeness on the part of management, or an attempt to be less than forthright with respect to litigation, claims, and assessments. Furthermore, a client's refusal to permit inquiry of its legal counsel ordinarily would result in a disclaimer of opinion. It would be unlikely that a CPA would accept a new engagement under these circumstances.
Choice "a" is incorrect. An understanding of the client's operations and industry should be obtained during the planning stage of the audit. It does not necessarily need to be obtained before acceptance of the engagement.
Choice "b" is incorrect. The fact that the entity has had recurring operating losses may increase the auditor's assessment of risk on the engagement, but it would not preclude acceptance of the engagement.
Choice "c" is incorrect. Although the predecessor's audit documentation provides some audit evidence with respect to opening balances, consistency of accounting principles, and other matters of continuing significance, alternative means of obtaining such evidence generally do exist.

QUESTION 229
An auditor ordinarily uses a working trial balance resembling the financial statements without footnotes, but containing columns for:

A. Reclassifications and adjustments.
B. Reconciliations and tickmarks.
C. Accruals and deferrals.

D. Expense and revenue summaries.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. An auditor's working trial balance generally contains columns for reclassifications and adjustments.
Choice "b" is incorrect. Reconciliations and tickmarks are included within audit documentation, but would not necessarily be shown in columns on the working trial balance.
Choice "c" is incorrect. Accruals and deferrals are included within audit documentation, but would not necessarily be shown in columns on the working trial balance.
Choice "d" is incorrect. Expense and revenue summaries are included within audit documentation, but would not necessarily be shown in columns on the working trial balance.

QUESTION 230
The audit documentation that makes up the current file most likely would include a copy of the:

A. Bank reconciliation.
B. Pension plan contract.
C. Articles of incorporation.
D. Flowchart of the internal control.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The audit documentation that makes up the current file most likely would include a copy of the bank reconciliation.
Choice "b" is incorrect. The audit documentation that makes up the permanent file would include a copy of the pension plan contract.
Choice "c" is incorrect. The audit documentation that makes up the permanent file would include a copy of the articles of incorporation. Choice "d" is incorrect. The audit documentation that makes up the permanent file would include a flowchart of the internal control.

QUESTION 231

The third standard of fieldwork states that the auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. The appropriate audit evidence required by this standard may be obtained, in part, through:

A. Flowcharting the internal control structure.
B. Proper planning of the audit engagement.
C. Analytical procedures.
D. Audit documentation.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Analytical procedures are substantive tests that provide audit evidence used to assess the reasonableness of account balances.
Choice "a" is incorrect. Flowcharting the internal control structure is used in obtaining an understanding of internal control, but it is not a procedure by which audit evidence is obtained.
Choice "b" is incorrect. Audit evidence with respect to the year-end financial statement balances generally is not obtained as part of the planning process.
Choice "d" is incorrect. Audit documentation describes the procedures followed and results of testing. Since it is prepared by the auditor, it does not represent audit evidence by itself.

QUESTION 232
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.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. In testing the existence assertion for an asset, an auditor ordinarily works from the accounting records to the supporting evidence.
Choice "a" is incorrect. If the auditor works from the financial statements, all items selected will have been recorded (i.e., because they are included in the financial statements). Therefore, starting with the financial statements will not lead to any unrecorded items.
Choice "b" is incorrect. Tracing potentially unrecorded items to the financial statements tests for completeness, not existence. Choice "d" is incorrect. Tracing from supporting evidence to the accounting records tests for completeness, not existence.

QUESTION 233
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 payable.
B. Advertising expense.
C. Accounts receivable.
D. Payroll expense.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Auditors try to identify predictable relationships when using analytical review procedures. Payroll expense is predictable because it is based on objective information (number of employees and pay rates). It can generally be computed directly by the auditor.
Choices "a", "b", and "c" are incorrect. These account balances are less predictable because they are affected by other factors. Payable and receivable balances can be affected by cash payments or receipts; advertising expense is subject to management discretion.

QUESTION 234
Which of the following statements concerning audit evidence is correct?

A. Reliable evidence supporting management's assertions should be conclusive rather than merely persuasive.
B. An effective internal control structure 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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Audit evidence consists of the underlying accounting data and all corroborating information available to the auditor. A client's accounting data by itself is not considered sufficient audit evidence to support the financial statements.
Choice "a" is incorrect. Reliable evidence supporting management's assertions only needs to be corroborative or persuasive, not conclusive.
Choice "b" is incorrect. An effective internal control structure contributes greatly to the reliability of the evidence created within the entity.
Choice "c" is incorrect. The cost of obtaining evidence is an important consideration to an auditor in selecting appropriate audit procedures. The cost of a procedure may be a valid reason for omitting that procedure, as long as an appropriate alternative procedure is available.

QUESTION 235
An auditor's purpose in reviewing the renewal of a note payable shortly after the balance sheet date most likely is to obtain evidence concerning management's assertions about:

A. Occurrence.
B. Understandability and classification.
C. Completeness.
D. Valuation and accuracy.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. An auditor's purpose in reviewing the renewal of a note payable shortly after the balance sheet date most likely is to obtain evidence concerning management's assertions about understandability and classification (i.e., classification of the note as current or noncurrent).
Choice "a" is incorrect. Occurrence relates to whether recorded transactions have actually occurred during the given period. Since the renewal took place subsequent to year-end, the auditor would not be concerned about how the transaction was actually recorded until the next reporting period.
Choice "c" is incorrect. Completeness relates to whether all transactions occurring in the period have been recorded. Since the renewal took place subsequent to year-end, it is not relevant to the completeness assertion for the year under audit.
Choice "d" is incorrect. Valuation and accuracy pertains to the fair disclosure of financial and other information at appropriate amounts. The renewal of a note payable shortly after year-end generally would not affect its valuation or its accuracy.

QUESTION 236
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 regarding:

A. Classification.
B. Cutoff.
C. Accuracy.
D. Existence.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Cutoff tests are designed to determine whether transactions have been recorded in the proper period. Tests to detect credit sales made before the end of the year that have been (improperly) recorded in the subsequent year provide assurance about both cutoff and completeness (i.e., whether all current year sales have been properly included).
Choice "a" is incorrect. Cutoff tests do not determine whether the components of the financial statements are properly presented, described and disclosed (classification).
Choice "c" is incorrect. The cutoff testing described is designed to identify sales recorded in the subsequent year that more properly belong in the current year. This relates to the timing of the entry, not to its accuracy. Choice "d" is incorrect. To test existence, the auditor would need to start with sales that were recorded in the current year, not those recorded in the subsequent year.

QUESTION 237
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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Inquiries of warehouse personnel concerning possible obsolete or slow-moving inventory items provide assurance about management's assertion of valuation (i.e., has inventory been properly recorded at lower of cost or market?).
Choice "a" is incorrect. Inquiries regarding obsolete or slow-moving inventory items provide little assurance regarding whether all transactions have been properly included (completeness).
Choice "b" is incorrect. Inquiries regarding obsolete or slow-moving inventory items provide little assurance regarding whether all recorded transactions are real (existence).
Choice "c" is incorrect. Inquiries regarding obsolete or slow-moving inventory items provide little assurance regarding whether all transactions are properly presented, described, and disclosed.

QUESTION 238
Which of the following statements is generally correct about the reliability of audit evidence?

A. The more effective the internal control structure, the more assurance it provides about the reliability of the accounting data and financial statements.
B. Reliability of audit evidence refers to the amount of corroborative evidence obtained.
C. Information obtained indirectly from independent outside sources is more persuasive than the auditor's direct personal knowledge obtained through observation and inspection.
D. Reliability of audit evidence refers to the audit evidence obtained from outside the entity.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The reliability of accounting data and financial statements is enhanced by a satisfactory system of internal control.
Choice "b" is incorrect. The sufficiency (not reliability) of audit evidence refers to the amount of corroborative evidence obtained. Reliability refers to the quality of evidence.
Choice "c" is incorrect. The auditor's direct personal knowledge obtained through observation and inspection is more persuasive than information obtained indirectly from independent outside sources. Choice "d" is incorrect. The reliability of audit evidence refers to its quality, and reliable audit evidence may be obtained from both inside and outside the entity.

QUESTION 239
Which of the following audit procedures probably would provide the most reliable evidence concerning the entity's assertion of rights and obligations related to inventories?

A. Trace test counts noted during the entity's physical count to the entity's summarization of quantities.
B. Inspect agreements to determine whether any inventory is pledged as collateral or subject to any liens.

C. Select the last few shipping advices used before the physical count and determine whether the shipments were recorded as sales.
D. Inspect the open purchase order file for significant commitments that should be considered for disclosure.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Inspecting agreements to determine whether any inventory is pledged as collateral or subject to liens provides the most reliable evidence concerning the entity's assertion of rights and obligations. These documents will probably verify ownership and show lenders' restrictions on the inventories.
Choice "a" is incorrect. Tracing from the auditor's test counts to the entity's summarization of quantities would provide evidence concerning the completeness assertion.
Choice "c" is incorrect. Determining whether shipments were recorded as sales provides evidence about the completeness of recorded sales.
Choice "d" is incorrect. Inspecting the open purchase order file for significant commitments that should be disclosed would provide evidence concerning the appropriate presentation, description, and disclosure of such items.

QUESTION 240
An auditor most likely would analyze inventory turnover rates to obtain evidence concerning management's assertions about:

A. Existence.
B. Rights and obligations.
C. Understandability and classification.
D. Valuation and allocation.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. An auditor most likely would analyze inventory turnover rates to obtain evidence concerning management's assertions about valuation and allocation (i.e., if the inventory is becoming older, an obsolescence reserve might be required).
Choice "a" is incorrect. The existence assertion addresses whether assets, liabilities, and equity interests exist. Analysis of inventory turnover would not provide evidence concerning this assertion.

Choice "b" is incorrect. Rights and obligations pertain to ownership of assets and liabilities. Analysis of inventory turnover would not provide evidence concerning this assertion.
Choice "c" is incorrect. Understandability and classification deal with whether the components of the financial statements are properly presented, described, and disclosed. Analysis of inventory turnover would not provide evidence concerning this assertion.

QUESTION 241
Which of the following procedures would an auditor most likely perform to verify management's assertion of completeness?

A. Compare a sample of shipping documents to related sales invoices.
B. Observe the client's distribution of payroll checks.
C. Confirm a sample of recorded receivables by direct communication with the debtors.
D. Review standard bank confirmations for indications of kiting.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. In order to verify management's assertion of completeness, an auditor would most likely compare a sample of shipping documents to related sales invoices to determine that all goods shipped were properly included in sales.
Choice "b" is incorrect. Observing the client's distribution of payroll checks would test management's assertion regarding existence of employees.
Choice "c" is incorrect. Confirming a sample of recorded receivables by direct communication with the debtors (i.e., sending accounts receivable confirmations) would verify management's assertion of existence of the accounts receivable. Choice "d" is incorrect. Reviewing standard bank confirmations does not provide evidence of kiting.
Kiting involves interbank transfers, and bank confirmations only show year-end balances, not transfers between banks.

QUESTION 242
Which of the following procedures would provide the most reliable audit evidence?

A. Inquiries of the client's internal audit staff held in private.
B. Inspection of prenumbered client purchase orders filed in the vouchers payable department.
C. Analytical procedures performed by the auditor on the entity's trial balance.
D. Inspection of bank statements obtained directly from the client's financial institution.

Correct Answer: D
Section: Volume D

Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. External evidence, such as bank statements obtained directly from the client's financial institution, is more reliable than internal evidence.
Choices "a", "b", and "c" are incorrect, which are all based on internally generated sources of evidence.

QUESTION 243
In a credit sales and cash receipts system flowchart symbol X could represent:

A. Auditor's test data.
B. Remittance advices.
C. Error reports.
D. Credit authorization forms.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Remittance advices (for customer payments) are the input document not identified in the credit sales and cash receipts system flowchart.
Choice "a" is incorrect. The flowchart shows the client's processing of receipts, not the auditor's tests of controls.
Choice "c" is incorrect. Error reports, also called exception reports, are generated after processing, not before.
Choice "d" is incorrect. Credit authorization forms would not be an input used to create a transaction file, although they should be used prior to granting credit.

QUESTION 244
Which of the following statements concerning audit evidence is correct?

A. To be appropriate, audit evidence should be either reliable or relevant, but need not be both.
B. The measure of the sufficiency of audit evidence lies in the auditor's judgment.
C. The difficulty and expense of obtaining audit evidence concerning an account balance is always a valid basis for omitting the test.
D. A client's accounting data can be sufficient audit evidence to support the financial statements.

Correct Answer: B

Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. The measure of the sufficiency of audit evidence lies in the auditor's judgment.
Choice "a" is incorrect. To be appropriate, audit evidence should be both reliable and relevant.
Choice "c" is incorrect. The difficulty and expense of obtaining audit evidence concerning an account balance is not a valid basis for omitting the test when there is no acceptable alternative procedure.
Choice "d" is incorrect. By itself, a client's accounting data cannot be sufficient audit evidence to support the financial statements. Sufficient, appropriate external evidence must also be obtained to corroborate management's assertions.

QUESTION 245
Which of the following presumptions does not relate to the reliability of audit evidence?

A. The more effective the internal control structure, the more assurance it provides about the accounting data and financial statements.
B. An auditor's opinion, to be economically useful, is formed within reasonable time and based on evidence obtained at a reasonable cost.
C. Evidence obtained from independent sources outside the entity is more persuasive than evidence secured solely within the entity.
D. The independent auditor's direct personal knowledge, obtained through observation and inspection, is more persuasive than information obtained indirectly.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. The concept of cost-benefit is embodied in the auditor's opinion which, to be economically useful, is formed within reasonable time and based on evidence obtained at a reasonable cost. The cost-benefit concept, however, bears no relationship to the reliability of audit evidence.
Choice "a" is incorrect. The more effective the internal control structure, the higher level of assurance it provides about the accounting data and financial statements, and the more reliable audit evidence will be.
Choice "c" is incorrect. Evidence obtained from independent sources outside the entity is more persuasive, or reliable, than evidence secured solely within the entity.
Choice "d" is incorrect. The independent auditor's direct personal knowledge, obtained through observation and inspection, is more persuasive (more reliable) than information obtained indirectly.

QUESTION 246

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 understandability and classification, and:

A. Valuation and allocation.
B. Completeness.
C. Existence.
D. Rights and obligations.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. An auditor reviews the overhead allocation to determine that no excessive costs for idle plant were charged to inventory. This is one of the procedures performed by an auditor to determine that the inventory balance is properly valued (assertion of valuation and allocation).
Choice "b" is incorrect. Completeness relates to ensuring that all assets, liabilities, and equity interests are properly included in the financial statements. The allocation of overhead costs to inventory does not affect this assertion.
Choice "c" is incorrect. Existence relates to whether assets, liabilities, and equity interests exist. The allocation of overhead costs to inventory does not affect this assertion. Choice "d" is incorrect. Rights and obligations pertain to ownership of assets and liabilities. The allocation of overhead costs to inventory does not affect this assertion.

QUESTION 247
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 and obligations.
B. Completeness.
C. Existence.
D. Valuation.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. When an auditor selects items for test counts and traces the test counts to the client's inventory listing, the auditor has obtained evidence concerning management's assertion of completeness (All inventory on hand has been properly included in the physical listing.)
Choice "a" is incorrect. The assertion of rights and obligations would be tested by examining paid vendor's invoices, consignment agreements, and contracts.
Choice "c" is incorrect. The assertion of existence would be supported by selecting from a sample of inventory items included in the physical listing and tracing to the floor to determine that the inventory was actually on hand. (Note how changing the direction of testing provides evidence for different assertions.)
Choice "d" is incorrect. Valuation pertains to presentation of balances at their appropriate amounts, whereas tracing test counts to the client's inventory listing relates to the testing of inventory quantities.

QUESTION 248
In testing plant and equipment balances, an auditor examines new additions listed on an analysis of plant and equipment. This procedure most likely obtains evidence concerning management's assertion of:

A. Completeness.
B. Existence.
C. Understandability and classification.
D. Valuation and allocation.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. By examining the assets listed as new additions on an analysis of plant and equipment, an auditor obtains evidence concerning management's assertion of existence.
Choice "a" is incorrect. Examining new additions that are already listed on the analysis does not provide evidence of completeness. The assertion of completeness relating to fixed assets might be tested by reviewing large repair and maintenance charges to determine if the cost should more properly have been capitalized (i.e., to evaluate whether fixed asset additions are complete).
Choice "c" is incorrect. Understandability and classification deals with whether the components of the financial statements are properly presented, described, and disclosed. Examination of new assets does not provide evidence regarding this assertion.
Choice "d" is incorrect. Valuation and allocation pertains to presentation of balances at their proper amounts. Examination of new assets does not provide evidence regarding this assertion.

QUESTION 249
Which of the following evidence provides the greatest assurance of reliability?

A. Bank statement.
B. Bank reconciliation.
C. Cash receipts journal.
D. Cash disbursements journal.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. External evidence is more reliable than internal evidence. A bank statement is external evidence.
Choices "b", "c", and "d" are incorrect. Bank reconciliations, the cash receipts journal, and the cash disbursements journal are all internal evidence, which is not as reliable as external evidence.

QUESTION 250
Which of the following evidence provides the least assurance of reliability?

A. Accounts receivable confirmation.
B. Sales invoice.
C. Vendor invoice.
D. Bank statement.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Internal evidence is less reliable than external evidence. A sales invoice is internal evidence.
Choices "a", "c", and "d" are incorrect. Accounts receivable confirmations, vendor invoices, and bank statements are all external evidence, which is more reliable than internal evidence.

QUESTION 251
Which of the following is not true about accounting estimates?

A. Accounting estimates measure the effects of past transactions or events that cannot be determined in a timely cost-effective manner.
B. Accounting estimates measure the effects of the present status of an asset or liability.
C. An accounting estimate is an approximation of an account pending the outcome of a future event.
D. An accounting estimate is an approximation of past events that can be determined on a timely cost effective basis.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. An accounting estimate pertains to determining the approximation of past events that cannot be determined on a timely, cost-effective basis. If the effect of a past event can be determined on a timely, cost-effective basis, there would be no reason to make an estimate.
Choices "a", "b", and "c" are incorrect. Accounting estimates may:
A. Measure the effects of past transactions that cannot be determined in a timely cost-effective manner.
B. Measure the effects of the present status of an asset or liability.
C. Be used to approximate an account pending the outcome of a future event (e.g., uncollectible accounts receivable).

QUESTION 252
An auditor should obtain sufficient knowledge of an entity's information system relevant to financial reporting to understand the:

A. Safeguards used to limit access to computer facilities.
B. Process used to prepare significant accounting estimates.
C. Procedures used to assure proper authorization of transactions.
D. Policies used to detect the concealment of irregularities.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. An auditor is responsible for evaluating the reasonableness of significant accounting estimates made by management. An entity's information system may affect the quality of such estimates and therefore should be considered by the auditor.

Choices "a", "c", and "d" are incorrect. Control activities such as those designed to limit access, ensure proper authorization, and discover fraud are not directly related to the information system relevant to financial reporting.

QUESTION 253
In evaluating an entity's accounting estimates, one of an auditor's objectives is to determine whether the estimates are:

A. Not subject to bias.
B. Consistent with industry guidelines.
C. Based on objective assumptions.
D. Reasonable in the circumstances.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. In evaluating an entity's accounting estimates, one of an auditor's objectives is to determine whether the estimates are reasonable in the circumstances and in conformity with GAAP.
Choice "a" is incorrect. Most estimates are subjective in nature and thus subject to bias.
Choice "b" is incorrect. Industry guidelines generally do not determine the amount of an accounting estimate, which is developed in accordance with GAAP.
Choice "c" is incorrect. Estimates are generally not based upon objective assumptions; rather, they are uncertain in nature, pending the outcome of future events.

QUESTION 254
Which of the following is true about an auditor's responsibility with respect to accounting estimates?

A. The auditor is responsible for both preparing accounting estimates and evaluating their reasonableness.
B. The auditor is responsible for preparing accounting estimates in accordance with generally accepted auditing standards.
C. The auditor is responsible for evaluating the reasonableness of accounting estimates.
D. The auditor has no responsibility with respect to accounting estimates.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:

Section: Volume D

Choice "c" is correct. The auditor is responsible for evaluating the reasonableness of accounting estimates.
Choices "a" and "b" are incorrect. Management is responsible for establishing a process for preparing accounting estimates. Choice "d" is incorrect. The auditor must determine whether the accounting estimate is reasonable in the circumstances.

QUESTION 255
Which of the following is not a reason justifying the use of accounting estimates?

A. The valuation or measurement of some accounts is uncertain pending the outcome of future events.
B. Data about past events cannot be accumulated in a cost-effective manner.
C. Data about future events cannot be accumulated in a cost-effective manner.
D. Data about past events cannot be accumulated in a timely manner.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Accounting estimates are not used to measure future events. (Although, the measurement of some accounts may be uncertain pending the outcome of future events.)
Choice "a" is incorrect. Valuation of certain historical accounts is uncertain, and may be dependent upon the outcome of future events. Accounting estimates are used in such situations to more properly reflect the account balance. Choices "b" and "d" are incorrect. If data about past events cannot be accumulated in a timely, cost effective manner, accounting estimates may be required.

QUESTION 256
An auditor would be most likely to identify a contingent liability by obtaining a (an):

A. Accounts payable confirmation.
B. Transfer agent confirmation.
C. Standard bank confirmation.
D. Related party transaction confirmation.

Correct Answer: C
Section: Volume D

Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. An auditor would be most likely to identify a contingent liability by obtaining a standard bank confirmation, which has an "exceptions and comments" box that specifically discloses contingent liabilities as endorser of loans, for open letters of credit, etc.
Choice "a" is incorrect. Confirmations of accounts payable relate to existing liabilities, not to contingent liabilities. They are not always performed and rarely disclose contingencies.
Choice "b" is incorrect. Transfer agent confirmations relate to purchase and sale of securities. They are not always used and rarely disclose contingencies.
Choice "d" is incorrect. Confirmations of related party transactions relate to transactions that have already occurred. They are not always used and rarely disclose contingencies.

QUESTION 257
In evaluating the reasonableness of an accounting estimate, an auditor would be least likely to use which of the following approaches?

A. Review subsequent events or transactions occurring prior to audit completion.
B. Develop an independent expectation of the estimate.
C. Review and test the process used to develop the estimate.
D. Review the minutes of board of directors and shareholder meetings for discussion of the estimate.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Even if estimates were discussed during board meetings and/or shareholder meetings, it is unlikely that review of such discussion would provide evidence that the estimate is reasonable.
Choices "a", "b", and "c" are incorrect. Reviewing subsequent events, developing an independent expectation, and reviewing and testing the process used to develop the estimate are all appropriate methods used to evaluate the reasonableness of an accounting estimate.

QUESTION 258
The sampling unit in a test of controls pertaining to the existence of payroll transactions ordinarily is a (an):

A. Clock card or time ticket.

B. Employee Form W-2.
C. Employee personnel record.
D. Payroll register entry.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. To test controls pertaining to the existence of payroll transactions, entries in the payroll register would be the population from which the sample is selected. (To test existence, the auditor needs to start with the accounting records and vouch backward to the source documents.)
Choice "a" is incorrect. After the sample is taken from the payroll register, the selected samples are traced to clock cards or time tickets to verify that payroll transactions really exist/occurred.
Choices "b" and "c" are incorrect. Sampling employee form W-2s and employee personnel records would test controls related to the completeness of recorded payroll, not existence of specific transactions.

QUESTION 259
Which of the following procedures most likely would be considered a weakness in an entity's internal controls over payroll?

A. A voucher for the amount of the payroll is prepared in the general accounting department based on the payroll department's payroll summary.
B. Payroll checks are prepared by the payroll department and signed by the treasurer.
C. The employee who distributes payroll checks returns unclaimed payroll checks to the payroll department.
D. The personnel department sends employees' termination notices to the payroll department.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. If the employee who distributes payroll checks returns unclaimed checks to the payroll department, an unscrupulous payroll department employee might be able to set up a fictitious employee and convert the checks once they are returned to the payroll department. Unclaimed checks should be turned over to the cashier in the treasurer's department. Choices "a", "b", and "d" are incorrect. All of the following procedures are good controls over the payroll system:

A. A voucher for the amount of the payroll is prepared in the general accounting department based on the payroll department's payroll summary.
B. Payroll checks are prepared by the payroll department and signed by the treasurer.
D. The personnel department sends employees' hire and termination notices to the payroll department.

QUESTION 260
An auditor most likely would perform substantive tests 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.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. An auditor most likely would perform substantive tests of details on payroll transactions and balances when analytical procedures indicate unusual fluctuations in recurring payroll entries. Generally an auditor can audit the payroll accounts utilizing mostly analytical procedures; however if the results of such procedures indicate unusual fluctuations, the auditor would employ more persuasive, substantive tests of details.
Choice "a" is incorrect. A substantial amount of accrued payroll expense would not necessarily cause the auditor to perform substantive tests of details on payroll transactions, since the balance may be effectively tested using analytical procedures.
Choice "b" is incorrect. When the assessed level of control risk relative to payroll is low, the auditor would probably perform only analytical procedures to test the related balances. If control risk rose to a high level, then substantive tests of details would probably be utilized.
Choice "d" is incorrect. Unpaid commissions may be tested effectively with analytical procedures.

QUESTION 261
The purpose of segregating the duties of hiring personnel and distributing payroll checks is to separate the:

A. Human resources function from the controllership function.
B. Administrative controls from the internal accounting controls.
C. Authorization of transactions from the custody of related assets.
D. Operational responsibility from the recordkeeping responsibility.

Correct Answer: C
Section: Volume D

Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The purpose of segregating the duties of hiring personnel (personnel department/human resources) and distributing payroll checks (treasurer's department) is to separate the authorization of transactions (hiring, pay rates, etc. are authorized by the personnel department/human resources) from the custody of related assets (cash or checks are held in the treasurer's department).
Choice "a" is incorrect. Segregation of hiring personnel (human resources/personnel) from distribution of payroll checks (treasurer's department) does not involve the controllership function. Choice "b" is incorrect. Keeping administrative controls (management's directives) and accounting controls separate is not accomplished by segregating the hiring and distribution functions. Choice "d" is incorrect. Neither operational responsibility nor recordkeeping responsibility includes distributing checks or hiring personnel.

QUESTION 262
An auditor most likely would extend substantive tests of payroll when:

A. Payroll is extensively audited by the state government.
B. Payroll expense is substantially higher than in the prior year.
C. Overpayments are discovered in performing tests of details.
D. Employees complain to management about too much overtime.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. An auditor most likely would extend (increase) substantive tests of payroll when significant errors, such as overpayments, are discovered in performing the tests of details.
Choice "a" is incorrect. The extensive auditing of payroll by the state government might serve to decrease substantive testing since presumably the extensive audit would have already flushed out any problem areas.
Choice "b" is incorrect. A substantial increase in payroll expense would not necessarily increase the substantive tests of payroll if the increase is readily explainable and supportable with analytical review procedures. Choice "d" is incorrect. An increase in overtime would not necessarily cause the auditor to extend substantive tests of payroll, as long as the effect on payroll is supportable with analytical review procedures.

QUESTION 263
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 exists between the preparation and distribution of the payroll.
D. Internal controls relating to unclaimed payroll checks are operating effectively.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. By vouching to time card data, the auditor is testing the existence assertion for hours worked.
Choice "a" is incorrect. Vouching to approved time card data would provide evidence about hours worked, not pay rates. Pay rates would be tested by comparing to personnel records.
Choice "c" is incorrect. Vouching to approved time cards does not provide evidence about segregation of duties.
Choice "d" is incorrect. Vouching to the approved time cards does not provide evidence about internal controls related to unclaimed paychecks. The auditor would need to observe a payroll distribution to evaluate these controls.

QUESTION 264
In a comparison of 20X2 to 20X1, Neir Co.'s inventory turnover ratio increased substantially although sales and inventory amounts were essentially unchanged. Which of the following statements explains the increased inventory turnover ratio?

A. Cost of goods sold decreased.
B. Accounts receivable turnover increased.
C. Total asset turnover increased.
D. Gross profit percentage decreased.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Gross profit percentage decreased.

$$\text{Inventory turnover ratio} = \frac{\text{Cost of sales}}{\text{Average inventory}}$$

In order for the inventory turnover ratio to increase, either cost of sales must increase or average inventory must decrease. Since the question-indicates that inventory is unchanged, cost of sales must have increased. If the cost of sales increased and sales remained constant, the gross profit percentage would decrease.
Choice "a" is incorrect. If cost of goods sold decreases, the inventory turnover ratio would also decrease.
Choice "b" is incorrect. Accounts receivable turnover is calculated as sales divided by receivables. If sales remain the same while this ratio increases, receivables have likely declined. This would have no impact on inventory turnover. Choice "c" is incorrect. Total asset turnover is calculated as sales divided by total assets. If sales remain the same while this ratio increases, total assets have likely declined. This would have no impact on inventory turnover.

QUESTION 265
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.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Confirmation of accounts receivable provides evidence that the customer and the receivable exist.
Choice "a" is incorrect. Accounts receivable confirmations do not provide evidence regarding valuation, since they do not indicate whether customers have the intent or the ability to pay.
Choice "b" is incorrect. Accounts receivable confirmations do not provide evidence regarding the appropriate classification of receivables in the financial statements.
Choice "d" is incorrect. Accounts receivable confirmations are sent to recorded customers, so they do not provide evidence regarding the possible omission of valid accounts (i.e., completeness).

QUESTION 266
Negative confirmation of accounts receivable is less effective than positive confirmation of accounts receivable because:

A. A majority of recipients usually lack the willingness to respond objectively.
B. Some recipients may report incorrect balances that require extensive follow-up.
C. The auditor cannot infer that all nonrespondents have verified their account information.
D. Negative confirmations do not produce audit evidence that is statistically quantifiable.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Negative confirmation of accounts receivable is less effective than positive confirmation of accounts receivable because the auditor cannot infer that all nonrespondents have verified their account information. Choice "a" is incorrect. Both positive and negative confirmations are equally affected by recipients' lack of willingness to respond objectively.
Choice "b" is incorrect. Both positive and negative confirms are equally affected by recipients' reporting of incorrect balances.
Choice "d" is incorrect. Negative confirmations returned do produce information (e.g., errors noted in accounts) that can be statistically quantifiable.

QUESTION 267
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 available to support the balances.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The documents available to support accounts payable balances come from external sources, which makes them more reliable.
Choice "a" is incorrect. Confirmation of accounts payable is not a duplication of cutoff tests. Cutoff testing addresses questions about proper period (allocation) while confirmation of accounts payable balances generally tests for understated balances.

Choice "b" is incorrect. If liabilities are not paid before the audit is completed, accounts payable confirmations would be more important, since there would be less other evidence supporting the liability.
Choice "c" is incorrect. Legal action usually takes a long time and correspondence with an attorney may not disclose all nonpayment problems. (Notice the all-inclusive word "all," usually the tip-off to a wrong answer.)

QUESTION 268
Two assertions for which confirmation of accounts receivable balances provides primary evidence are:

A. Completeness and valuation.
B. Valuation and rights and obligations.
C. Rights and obligations and existence.
D. Existence and completeness.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Two assertions for which the confirmation of accounts receivable balances provides primary evidence are rights and obligations (does the client have a right to the receivable?) and existence (does the receivable really exist?).
Choices "a", "b", and "d" are incorrect. Confirmation of receivables does not provide evidence about completeness, since the sample begins with recorded receivables. (To test completeness, we would be looking for unrecorded receivables). In addition, confirmation of receivables does not necessarily provide evidence related to the valuation assertion. While the existence of the receivables is confirmed, their collectibility is not.

QUESTION 269
The negative request form of accounts receivable confirmation is useful particularly when the:

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The negative request form of accounts receivable confirmation is useful particularly when:
- the assessed level of control risk relating to receivables is low (if control risk is high, then positive confirmation requests would probably be sent),
- there are many small balances (which would make it difficult to keep the number of positiveconfirmations to a reasonably low level), and
- consideration of the confirmation by the recipient is likely (since the auditor is relying on thecustomers' consideration as the sole basis of support for the confirmation). Choices "b", "c", and "d" are incorrect, based on the above .

QUESTION 270
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 the internal control structure 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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. When an auditor does not receive replies to second requests on year-end accounts receivable confirmations, the auditor would most likely perform alternate procedures to support the existence of the receivables. These procedures include inspection of the shipping records to determine that the merchandise was actually sold to the debtors.
Choice "a" is incorrect. Alternate procedures would also include reviewing the cash receipts journal for the months subsequent to year-end. Reviewing the cash receipts journal for the month prior to year-end would provide no evidence regarding the existence of a year-end receivable, which obviously had not been paid by year-end.
Choice "b" is incorrect. Intensifying the study of the internal control structure concerning the revenue cycle would provide no additional evidence related to the specific accounts receivable confirmations that were not returned.
Choice "c" is incorrect. Increasing the assessed level of detection risk for the existence assertion would provide no additional evidence related to the specific accounts receivable confirmations that were not returned by the customer. (By sending out confirmations, the auditor is already performing substantive tests).

QUESTION 271

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.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The use of negative confirmations most likely would be justified when there are a small number of accounts that may be in dispute and the accounts receivable balance arises from sales to many customers with small balances (e.g., utility consumer customers).
Choice "a" is incorrect. Positive (not negative) confirmations should be used when a substantial number of accounts are expected to be in dispute, or if the accounts receivable balance is comprised of accounts from a few major customers. Choice "b" is incorrect. Positive (not negative) confirmations should be used when a substantial number of accounts are expected to be in dispute.
Choice "c" is incorrect. Positive (not negative) confirmations should be used when the accounts receivable balance is comprised of accounts from a few major customers.

QUESTION 272
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.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. In order to validate the legitimacy of a faxed confirmation, the auditor is likely to call the senders to verify the sources and contents.
Choice "a" is incorrect. Examining shipping documents is an alternative procedure that is more likely to be performed if the confirmation was not received at all.
Choice "c" is incorrect. Treating the faxes as non-responses would be to ignore an important source of audit evidence. Treating them as unadjusted differences may cause the auditor to conclude that the accounts receivable balance is misstated, when in fact it is not.
Choice "d" is incorrect. Inspecting the faxes for forgeries or alterations is beyond the professional capability of the CPA.

QUESTION 273
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.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. If the recipients of confirmations are likely to sign them without devoting proper attention to them, it is possible that a misstatement in the related receivable will not be discovered by the auditor (i.e., when the balance on the confirmation is incorrect and the recipient mistakenly signs it anyway). Use of the blank form of confirmation provides a greater degree of assurance in this situation because it forces the recipient to determine the receivable balance.
Choice "b" is incorrect. Inability to verify subsequent cash receipts makes follow-up of unconfirmed accounts more difficult. Since blank forms may result in lower response rates (because they require additional effort), use of the blank form in this situation would be less likely.
Choice "c" is incorrect. If few exceptions are expected, it would be acceptable to use positive confirmations. (Blank confirmations may provide a greater degree of assurance, which would be more important if many exceptions were expected.)
Choice "d" is incorrect. In low risk situations, it would be acceptable to use positive confirmations. (Blank confirmations may provide a greater degree of assurance, which would be more important in high risk situations.)

QUESTION 274
To establish the existence and ownership of a long-term investment in the common stock of a publicly traded company, an auditor ordinarily performs a security count or:

A. Relies on the client's internal accounting controls if the auditor has reasonable assurance that the control activities are being applied as prescribed.
B. Confirms the number of shares owned that are held by an independent custodian.

C. Determines the market price per share at the balance sheet date from published quotations.
D. Confirms the number of shares owned with the issuing company.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Auditors obtain a confirmation (safekeeping list) indicating the number of shares of stocks held by an outside independent custodian.
Choice "a" is incorrect. Even a good system of internal control does not necessarily provide sufficient evidence of existence and ownership.
Choice "c" is incorrect. Verifying the market price doesn't provide evidence regarding ownership or existence.
Choice "d" is incorrect. Confirmations are generally sent to the independent custodian, not to the issuing company.

QUESTION 275
An auditor testing long-term investments would ordinarily use analytical review as the primary audit procedure to ascertain the reasonableness of the:

A. Valuation of marketable equity securities.
B. Classification of gains and losses on the disposal of securities.
C. Completeness of recorded investment income.
D. Existence and ownership of investments.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Analytical review is generally used to ascertain the reasonableness of investment income in relationship to the amount invested.
Choice "a" is incorrect. Valuation would be verified using listed prices (NYSE, etc.).
Choice "b" is incorrect. Classification of gains or losses would be evaluated based upon appropriate accounting principles.
Choice "d" is incorrect. Existence and ownership is generally evaluated by inspection of securities, review of brokerage statements, or confirmation with an outside independent custodian.

QUESTION 276

An auditor would most likely verify the interest earned on bond investments by:

A. Vouching the receipt and deposit of interest checks.
B. Confirming the bond interest rate with the issuer of the bonds.
C. Recomputing the interest earned on the basis of face amount, interest rate, and period held.
D. Testing the internal controls over cash receipts.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Recomputing the interest earned is the most likely method of auditing interest earned on bond investments.
Choice "a" is incorrect. Vouching cash receipts would only verify the recording of checks received. This may not be the same as interest earned, since interest is accrued between cash payment dates.
Choice "b" is incorrect. Confirmation of the bond interest rate with the issuer is not sufficient, as the rate still needs to be applied based on face amount and period held.
Choice "d" is incorrect. Internal control testing of cash receipts would not provide evidence that earned interest was properly recorded, since interest is accrued between cash payment dates.

QUESTION 277
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 safety 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 safety deposit box by independent personnel.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. An independent person comparing the contents of the safety deposit box with the recorded balances in the investment subsidiary ledger is an effective control for assuring that the proper custody of assets in the investing cycle is maintained.
Choice "a" is incorrect. Direct access to securities in the safety deposit box being limited to only one corporate officer is a weakness in internal control since there is no independent verification of the box's contents. Good internal control generally requires that two or more individuals be present when the safety deposit box is opened.
Choice "b" is incorrect. While it is a good idea to have separate employees post investment transactions to the general and subsidiary ledgers (so they can later be reconciled), this control relates to recordkeeping, not to custody.
Choice "c" is incorrect. Authorization of the purchase and sale of investments by the board of directors is a good control over the approval of investment transactions but does little to assure that proper custody of assets is maintained.

QUESTION 278
To satisfy the valuation assertion when auditing an investment accounted for by the equity method, an auditor most likely would:

A. Inspect the stock certificates evidencing the investment.
B. Examine the audited financial statements of the investee company.
C. Review the broker's advice or canceled check for the investment's acquisition.
D. Obtain market quotations from financial newspapers or periodicals.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. To satisfy the valuation assertion when auditing an investment accounted for by the equity method, an auditor most likely would examine the audited financial statements of the investee company, performing recalculations of prorata share of income/loss and analytical procedures to determine if the investment is carried at the lower of cost or market.
Choices "a" and "c" are incorrect. Inspecting the stock certificates evidencing the investment or reviewing the broker's advice or canceled check for the investment's acquisition are procedures that satisfy the existence assertion, not the valuation assertion.
Choice "d" is incorrect. Obtaining market quotations from financial newspapers or periodicals would satisfy the valuation assertion for an investment accounted for by the cost method.

QUESTION 279
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.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The control most likely to be used by an entity in safeguarding against the loss of marketable securities is that an independent trust company that has no direct contact with the employees who have recordkeeping responsibilities, has possession of the securities. For good internal control over the safeguarding of any asset, the individual who has the recordkeeping responsibilities over that asset should never have access to it.
Choice "b" is incorrect. Verifying the securities held in the entity's safe would detect that the loss occurred, but it would not prevent the loss.
Choice "c" is incorrect. Tracing purchases and sales of marketable securities would verify that the transactions were properly recorded, but would not safeguard against loss.
Choice "d" is incorrect. Having one person control the securities in a bank safe-deposit box is a weakness in internal control because that one person can steal the securities. A better system requires that at least two employees have joint control over the securities in a bank safe-deposit box.

QUESTION 280
Which of the following controls most likely would give the greatest assurance that securities held as investments are safeguarded?

A. There is no access to securities between the year-end and the date of the auditor's security count.
B. Proceeds from the sale of investments are received by an employee who does not have access to securities.
C. Investment acquisitions are authorized by a member of the Board of Directors before execution.
D. Access to securities requires the signatures and presence of two designated officials.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. Requiring the signatures and presence of two designated officials in order to gain access to securities is an internal control that provides assurance regarding the safeguarding of securities.
Choice "a" is incorrect. Having no access to securities between the year-end and the date of the auditor's security count would assure that no securities are

added or taken away before the auditor counts them, but it would not ensure that securities are safeguarded for the entire year.
Choice "b" is incorrect. Proceeds from the sale of investments should be received by an employee who does not have access to securities, but this control does not prevent the theft of investments that are not sold.
Choice "c" is incorrect. Requiring authorization from a member of the board of directors before execution assures that investment purchases are approved and consistent with the financial philosophy of the organization (level of financial risk that the company is willing to accept), but this approval does not provide assurance that the assets will be safeguarded.

QUESTION 281
In testing long-term investments, an auditor ordinarily would use analytical procedures to ascertain the reasonableness of the:

A. Completeness of recorded investment income.
B. Classification between balance sheet portfolios.
C. Valuation of marketable equity securities.
D. Existence of unrealized gains or losses in the portfolio.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. In testing long-term investments, an auditor ordinarily would use analytical procedures to ascertain the reasonableness of the completeness of recorded investment income. These procedures would probably include a comparison of the recorded investment income with the expected amount (based upon the related interest rate, dividends declared, etc.) and the income balance audited in the prior year.
Choice "b" is incorrect. Classification between balance sheet portfolios would most likely be tested by confirming the terms of the investment and making inquiries of management regarding how long they intend to hold the securities.
Choice "c" is incorrect. To test the valuation of marketable equity securities an auditor would most likely compare to market quotations (cost method) or examine the audited financial statements of the investee company (equity method). Choice "d" is incorrect. To identify and quantify the existence of unrealized gains and losses in the portfolio, an auditor would examine the trading prices in the Wall Street Journal (or other source) for those long-term investments carried under the cost method. For those carried under the equity method, an auditor would review the audited financial statements of the investee company.

QUESTION 282
Which of the following internal 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.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Requiring the internal auditor to compare the securities in the bank safe deposit box with recorded investments is the procedure an entity most likely would use in satisfying the completeness assertion related to longterm investments.
Choice "a" is incorrect. Verifying that securities in the bank safe deposit box are registered in the entity's name provides evidence regarding rights and obligations, not completeness.
Choice "c" is incorrect. Vouching the acquisition of securities by comparing brokers' advices with canceled checks provides evidence regarding rights and obligations, not completeness.
Choice "d" is incorrect. The controller comparing the current market prices of recorded investments with the broker advices on file provides assurance that the long-term investments are properly valued, and that unrealized gains and losses are properly recognized.

QUESTION 283
A client has a large and active investment portfolio that is kept in a bank safe deposit box. If the auditor is unable to count the securities at the balance sheet date, the auditor most likely will:

A. Request the bank to confirm to the auditor the contents of the safe deposit box at the balance sheet date.
B. Examine supporting evidence for transactions occurring during the year.
C. Count the securities at a subsequent date and confirm with the bank whether securities were added or removed since the balance sheet date.
D. Request the client to have the bank seal the safe deposit box until the auditor can count the securities at a subsequent date.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. If the auditor is unable to count the securities at the balance sheet date the auditor should request the client to have the bank seal the safe deposit box until the auditor can count the securities.
Choice "a" is incorrect. Bank employees are not present when items are put into or taken from the safety deposit box and do not keep records of safety deposit box contents. They would therefore be unable to provide any information to the auditors.

Choice "b" is incorrect. Examining supporting evidence for the transactions occurring during the year is inefficient, as many of the securities purchased during the year may have been sold before the balance sheet date. Counting securities is preferable as it provides direct external evidence of the securities on hand at year-end.
Choice "c" is incorrect. Bank employees are not present when items are put into or taken from the safety deposit box and do not keep records of safety deposit box contents. They would therefore be unable to provide any information to the auditors.

QUESTION 284
Property acquisitions that are misclassified as maintenance expense would most likely be detected by an internal accounting control system that provides for:

A. Investigation of variances within a formal budgeting system.
B. Review and approval of the monthly depreciation entry by the plant supervisor.
C. Segregation of duties of employees in the accounts payable department.
D. Examination by the internal auditor of vendor invoices and canceled checks for property acquisitions.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Investigation of variances in a formal budget might show maintenance costs over budget or acquisition costs under budget, either of which would trigger an investigation.
Choice "b" is incorrect. Review of journal entries relating to depreciation would not disclose acquisitions misclassified as maintenance expense, since no depreciation would be recorded for the misclassified items.
Choice "c" is incorrect. Segregation of duties in the accounts payable department would have no effect on the account classification of an approved invoice.
Choice "d" is incorrect. Since the internal auditor would be looking at invoices and checks related to recorded property acquisitions, he or she would not be likely to identify payments that were erroneously excluded from the property account.

QUESTION 285
Which of the following controls is most likely to prevent the improper disposition of equipment?

A. A separation of duties between those authorized to dispose of equipment and those authorized to approve removal work orders.
B. The use of serial numbers to identify equipment that could be sold.
C. Periodic comparison of removal work orders to authorizing documentation.
D. A periodic analysis of the scrap sales and the repairs and maintenance accounts.

Correct Answer: A

Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Separation of duties between those authorized to dispose of equipment and those authorized to approve removal work orders is most likely to prevent the improper disposition of equipment.
Choice "b" is incorrect. Serial number tracking is a good audit and control activity but it will not prevent improper dispositions of equipment.
Choices "c" and "d" are incorrect. Periodic comparison of removal work orders to authorizing documentation and periodic analysis of scrap sales and the repairs and maintenance accounts may identify improper dispositions that have already occurred, but such procedures will not prevent improper dispositions.

QUESTION 286
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 (an):

A. Insurance premium due but not recorded.
B. Deficiency in the coinsurance provision.
C. Lien on the plant equipment.
D. Understatement of insurance expense.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. If an auditor discovers that the original insurance policy on plant equipment is not available for inspection, this most likely indicates that there is a lien on the plant equipment, since the original policy would likely be in the possession of the lien holder.
Choices "a", "b", and "d" are incorrect. The absence of the original policy does not necessarily indicate that there is an insurance premium due but not recorded, that there is a deficiency in the coinsurance provision, or that insurance expense is understated, since the policy must be reviewed before any of these conclusions can be drawn.

QUESTION 287
Which of the following combinations of procedures would an auditor most likely perform to obtain evidence about fixed asset additions?

A. Inspecting documents and physically examining assets.

B. Recomputing calculations and obtaining written management representations.
C. Observing operating activities and comparing balances to prior period balances.
D. Confirming ownership and corroborating transactions through inquiries of client personnel.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. In order to obtain evidence about fixed asset additions, an auditor would most likely inspect documents (e.g., purchase invoices) and physically examine the new assets.
Choice "b" is incorrect. Recomputing calculations might provide evidence about depreciation, and obtaining management representations might provide evidence about commitments with respect to fixed assets, but neither procedure provides specific evidence about fixed asset additions.
Choice "c" is incorrect. Observing operating activities and comparing balances to prior years might provide evidence that depreciation expense was properly recorded, but does not provide evidence supporting additions. Choice "d" is incorrect. Inquiry alone is not as persuasive as direct personal observation.

QUESTION 288
Which of the following internal controls most likely would justify a reduced assessed level of control risk concerning plant and equipment acquisitions?

A. Periodic physical inspection of plant and equipment by the internal audit staff.
B. Comparison of current-year plant and equipment account balances with prior-year actual balances.
C. The review of prenumbered purchase orders to detect unrecorded trade-ins.
D. Approval of periodic depreciation entries by a supervisor independent of the accounting department.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Periodic physical inspection of plant and equipment by the internal audit staff is an internal control that would most likely justify a reduced assessed level of control risk concerning plant and equipment acquisitions. Such inspections would provide assurance that recorded acquisitions are real (existence assertion).
Choice "b" is incorrect. The comparison of current-year plant and equipment account balances with prioryear actual balances might indicate that acquisitions

occurred, but it would not justify a reduced assessed level of control risk, since the controls over the acquisition process are not tested.
Choice "c" is incorrect. A review of prenumbered purchase orders is unlikely to provide evidence regarding plant and equipment acquisitions. (Generally a special requisition form is used for such acquisitions.) Choice "d" is incorrect. Approval of depreciation entries has little bearing on the control risk relating to plant and equipment acquisitions.

QUESTION 289
Equipment acquisitions that are misclassified as maintenance expense most likely would be detected by an internal control activity that provides for:

A. Segregation of duties of employees in the accounts payable department.
B. Independent verification of invoices for disbursements recorded as equipment acquisitions.
C. Investigation of variances within a formal budgeting system.
D. Authorization by the board of directors of significant equipment acquisitions.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. Equipment acquisitions that are misclassified as maintenance expense most likely would be detected by internal control procedures that provide for investigation of variances within a formal budgeting system.
Choice "a" is incorrect. Segregation of duties of employees in the accounts payable department would not prevent the misclassification of equipment acquisitions as maintenance expense.
Choice "b" is incorrect. Verifying invoices for disbursements already recorded as equipment acquisitions would not include examining invoices for disbursements recorded as maintenance expense. Choice "d" is incorrect. Since the authorization by the board of directors occurs before the disbursement is recorded, this control would not prevent any misclassification.

QUESTION 290
In testing for unrecorded retirements of equipment, an auditor most likely would:

A. Select items of equipment from the accounting records and then locate them during the plant tour.
B. Compare depreciation journal entries with similar prior-year entries in search of fully depreciated equipment.
C. Inspect items of equipment observed during the plant tour and then trace them to the equipment subsidiary ledger.
D. Scan the general journal for unusual equipment additions and excessive debits to repairs and maintenance expense.

Correct Answer: A
Section: Volume D

Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Tracing (old) equipment recorded in the books to the actual equipment during a plant tour is a control which tests for unrecorded retirements.
Choice "b" is incorrect. Determining which assets are fully depreciated does not tell you which ones are retired, as fully depreciated assets may continue to be used.
Choice "c" is incorrect. Selecting items from the plant tour and then tracing them to the equipment subsidiary ledger will provide evidence that all equipment is recorded. It will not detect whether recorded equipment has been retired. (This step is backwards.)
Choice "d" is incorrect. Scanning the general journal for unusual equipment additions and excessive debits to repairs and maintenance expense provides evidence regarding fixed asset additions, not retirements.

QUESTION 291
An auditor ordinarily sends a standard confirmation request to all banks with which the client has done business during the year under audit, regardless of the year-end balance. A purpose of this procedure is to:

A. Provide the data necessary to prepare a proof of cash.
B. Request a cutoff bank statement and related checks be sent to the auditor.
C. Detect kiting activities that may otherwise not be discovered.
D. Seek information about contingent liabilities and security agreements.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The standard confirmation request seeks information on contingent liabilities and security agreements in addition to information related to deposit account balances.
Choice "a" is incorrect. The standard confirmation request does not provide all of the data necessary to prepare a "proof of cash" (i.e., bank reconciliation), since it only confirms the balances at the end of a period, and does not provided information about the activity during the period under audit. Such information is necessary to perform a bank reconciliation and would be provided in a bank statement.
Choice "b" is incorrect. A request for a cut-off statement, and not the standard bank confirmation form, is used to obtain a cut-off bank statement and related checks. Choice "c" is incorrect. The bank cut-off statement, not the standard confirmation request, is used to detect kiting activities that may not otherwise be discovered.

QUESTION 292
In an audit of contingent liabilities, which of the following procedures would be least effective?

A. Reviewing a bank confirmation letter.
B. Examining customer confirmation replies.
C. Examining invoices for professional services.
D. Reading the minutes of the board of directors.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. Customer confirmations relate to receivables, and would not be likely to disclose a contingent liability.
Choice "a" is incorrect. A standard bank confirmation will most likely identify contingent liabilities because it contains confirmation of discounted drafts and/or guarantees of notes and/or other open letters of credit.
Choice "c" is incorrect. Examining professional invoices may disclose a contingent liability. For example, invoices from attorneys may provide information regarding litigation, claims, and assessments. Choice "d" is incorrect. Reviewing the board minutes may identify a contingent liability. For example, the board may discuss contingencies during one of its meetings. Other procedures that may be effective in an audit of contingent liabilities include:
Discussing long-term purchase commitments with the purchasing agent.
Reviewing long-term leases.
Obtaining a client representation letter.

QUESTION 293
The primary evidence regarding year-end cash balances in the financial statements is documented in the:

A. Standard bank confirmations.
B. Bank reconciliations.
C. Interbank transfer schedule.
D. Bank deposit lead schedule.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. The primary evidence regarding year-end cash balances in the financial statements is documented in the bank reconciliation, which reconciles the balance per the bank to that per the financial statements.
Choice "a" is incorrect. The standard bank confirmation does not provide evidence about certain transactions that are necessary to compute the cash balance, such as deposits in transit and outstanding checks.
Choice "c" is incorrect. The interbank transfer schedule provides evidence about bank transfers over a period of time. It is used to detect kiting, not to support the year-end cash balance.
Choice "d" is incorrect. A "cash lead schedule" is a schedule that summarizes all the various balances that comprise cash. It is created by the auditor and is not, in and of itself, evidence supporting cash.

QUESTION 294
An auditor's program to examine long-term debt should include steps that require:

A. Examining bond trust indentures.
B. Inspecting the accounts payable subsidiary ledger.
C. Investigating credits to the bond interest income account.
D. Verifying the existence of the bondholders.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. Examination of bond trust indentures should be included in audit program of longterm debt to assure that the client was not in violation of any covenants in the indentures. Choice "b" is incorrect. Inspecting the accounts payable subsidiary ledger relates to accounts payable, a current liability.
Choice "c" is incorrect. Long-term debt generates interest expense, not interest income.
Choice "d" is incorrect. Generally, the existence of the bondholders of debt is not verified.

QUESTION 295
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.

Correct Answer: A
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "a" is correct. The scope of an audit is not restricted when an attorney's response is limited to matters to which the attorney has given substantive attention in the form of legal representation. The attorney may also limit his or her response to matters that are considered individually or collectively to be material.
Choices "b", "c", and "d" are incorrect. The scope of an audit may be restricted when an attorney's response is limited to:
1. An evaluation of the likelihood of an unfavorable outcome of the matter disclosed by the entity. (The attorney's response should also address the nature of the claim, the progress to date, and the intended response.)
2. The attorney's opinion of the entity's historical experience in recent similar litigation. (The attorney's response should address the current situation, which may not parallel historical experience).
3. The probable outcome of asserted claims and pending or threatened litigation. (The attorney's response should also address the nature of the claim, the progress to date, and the intended response, as well as unasserted claims).

QUESTION 296
An auditor's plan to examine long-term debt most likely would include steps that require:

A. Comparing the carrying amount of the debt to its year-end market value.
B. Correlating interest expense recorded for the period with outstanding debt.
C. Verifying the existence of the holders of the debt by direct confirmation.
D. Inspecting the accounts payable subsidiary ledger for unrecorded long-term debt.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. An auditor's plan to examine long-term debt most likely would include steps that require correlating interest expense recorded for the period

with outstanding debt. This is an analytical procedure that would provide evidence regarding the reasonableness of the interest expense balance.
Choice "a" is incorrect. This question-was released prior to the issuance of FAS 107, which requires disclosure of the fair values of financial instruments. Accordingly, the auditor now needs to audit the year-end market values of long-term debt. Choice "a" is still not the best answer, however, since the auditor would not need to compare the carrying amount to the year-end market value. (Both values are shown, as FAS 107 does not require that debt securities be written down to (a lower) market value.)
Choice "c" is incorrect. Generally the existence of the holders of the debt is not verified.
Choice "d" is incorrect. Inspecting the accounts payable subsidiary ledger would be included in the audit of accounts payable, not long-term debt.

QUESTION 297
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 controls 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.

Correct Answer: B
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "b" is correct. The independent auditor would not confirm directly with the client's lawyer that all claims have been recorded in the financial statements. Management has the responsibility to include all claims in the financial statements, not the lawyers. The purpose of a legal letter is to obtain outside corroboration of the information furnished by management concerning litigation, claims, and assessments.
Choice "a" is incorrect. The auditor should obtain assurance from management that it has disclosed all unasserted claims that the lawyer has advised are probable of assertion and must be disclosed.
Choice "c" is incorrect. The auditor should inquire of and discuss with management the controls adopted for identifying, evaluating, and accounting for litigation, claims, and assessments. Choice "d" is incorrect. The auditor should obtain from management a description and evaluation of litigation, claims, and assessments existing at the balance sheet date.

QUESTION 298
An auditor should request that an audit client send a letter of inquiry to those attorneys who have been consulted concerning litigation, claims, or assessments. The primary reason for this request is to provide:

A. The opinion of a specialist as to whether loss contingencies are possible, probable, or remote.
B. A description of litigation, claims, and assessments that have a reasonable possibility of unfavorable outcomes.

C. An objective appraisal of management's controls adopted for identifying and evaluating legal matters.
D. The corroboration of the information furnished by management concerning litigation, claims, and assessments.

Correct Answer: D
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "d" is correct. The primary reason for an auditor to request that the audit client send a letter of inquiry to its attorneys is to provide corroboration of the information furnished by management concerning litigation, claims and assessments.
Choice "a" is incorrect. The letter of inquiry is used to corroborate information furnished by management.
The likelihood of loss contingencies occurring is only one item addressed in this correspondence, but it is not the primary purpose of the request.
Choice "b" is incorrect. The description of litigation, claims and assessments that have a reasonable possibility of unfavorable outcomes should be provided by management, not the attorneys. Choice "c" is incorrect. The attorneys do not give an appraisal of management's controls adopted for identifying and evaluating legal matters.

QUESTION 299
The most likely result of ineffective internal control policies and procedures in the revenue cycle is that:

A. Irregularities in recording transactions in the subsidiary accounts could result in a delay in goods shipped.
B. Omission of shipping documents could go undetected, causing an understatement of inventory.
C. Final authorization of credit memos by personnel in the sales department could permit an employee defalcation scheme.
D. Fictitious transactions could be recorded, causing an understatement of revenues and overstatement of receivables.

Correct Answer: C
Section: Volume D
Explanation

Explanation/Reference:
Section: Volume D

Choice "c" is correct. The most likely result of ineffective internal control policies and procedures in the revenue cycle is that final authorization of credit memos by personnel in the sales department could permit a salesman to sell, collect, and pocket the collection, then cover it up by issuing a credit memo.
Final authorization of credit memos should be performed by an employee who is independent of the sales department such as the credit manager in the treasury department.

Choice "a" is incorrect. The shipment of goods is an activity that takes place before the transaction is recorded. Irregularities in recording transactions in the subsidiary accounts therefore would have no impact on the timeliness of the goods being shipped.
Choice "b" is incorrect. If shipping documents are omitted, then the inventory levels would be overstated since the reduction of inventory would not be recorded.
Choice "d" is incorrect. If fictitious transactions in the revenue cycle are recorded, then the impact on revenues and receivables would be the same; either both would be overstated (the most likely case) or both would be understated.

QUESTION 300
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?

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. An internal control questionnaire for notes payable would likely ask if direct borrowings on notes payable are authorized by the board of directors.
Choice "a" is incorrect. Whether collateralized assets are critically needed for the entity's continued existence is not a part of the control environment related to notes payable.
Choice "b" is incorrect. The requirement for two authorized signatures is part of the disbursements internal control system, not the notes payable system.
Choice "c" is incorrect. Whether the proceeds of notes payable are used for current or noncurrent assets is not a part of the notes payable internal control system.

QUESTION 301
In auditing accounts payable, an auditor's procedures most likely would focus primarily on management's assertion of:

A. Existence.
B. Understandability and classification.
C. Completeness.
D. Valuation and allocation.

Correct Answer: C

Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. When testing liabilities, an auditor generally is concerned about understatement (as opposed to overstatement, for assets). Therefore, in auditing accounts payable, an auditor's procedures most likely would focus primarily on management's assertion of completeness (if accounts payable is not complete it would be understated).
Choice "a" is incorrect. The assertion of existence is the primary focus of the auditor when auditing an asset account, not accounts payable.
Choice "b" is incorrect. The understandability and classification assertion is not the primary focus in the audit of accounts payable.
Choice "d" is incorrect. The assertion of valuation and allocation is not the main focus with respect to accounts payable. Good external evidence generally is available to support the amount, and allocation over more than one period generally is not required.

QUESTION 302
Which of the following statements extracted from a client's lawyer's letters 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."

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The auditor is concerned with preventing an understatement of contingent liabilities. The auditor would therefore request clarification before determining that a reduction in such liability (from damages claimed to some lesser amount) is reasonable.
Choices "a", "c", and "d" are incorrect. When a lawyer asserts that a contingent liability is immaterial ("nominal") or improbable ("without merit" and "successful defense likely"), it is unlikely that the auditor would require further clarification.

QUESTION 303
An auditor should trace corporate stock issuances and treasury stock transactions to the:

A. Numbered stock certificates.
B. Articles of incorporation.
C. Transfer agent's records.
D. Minutes of the board of directors.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The auditor should trace corporate stock issuances and treasury stock transactions to the minutes of the board of directors to make sure they were authorized.
Choice "a" is incorrect. Numbered stock certificates for shares that are issued and outstanding would be in the hands of the stockholders.
Choice "b" is incorrect. Information about stock issuances and treasury stock transactions would not be included in the articles of incorporation. Generally only the shares authorized and their par value would be included therein. Choice "c" is incorrect. The transfer agent might confirm a transaction, but the auditor would not generally review the transfer agent's records.

QUESTION 304
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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. When a client company does not maintain its own stock records, the auditor should request the transfer agent and registrar to confirm the number of shares issued and outstanding. Choice "a" is incorrect. Restrictions on the payment of dividends should be in the board minutes, or possibly confirmed by the bank if the restrictions are due to outstanding loan(s).

Choice "c" is incorrect. Guarantees of preferred stock liquidation value should be in the board minutes or the stock redemption agreement.
Choice "d" is incorrect. The number of shares subject to agreements to repurchase should be in the board minutes and in any repurchase agreements.

QUESTION 305
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.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Large companies often use a registrar to provide registration services and maintain the stockholder list. The primary responsibility of the registrar is to verify that stock is issued only with proper authorization.
Choice "a" is incorrect. The company's board of directors bears responsibility for proper declaration of dividends, not the stock registrar.
Choice "b" is incorrect. Since the company's management is responsible for maintaining accurate accounting records, a responsible company employee (not the registrar) would periodically compare the recorded number of shares outstanding (per company records) with the total in the shareholders' subsidiary ledger (per the registrar).
Choice "c" is incorrect. A registrar does not have the described responsibility with respect to mergers, acquisitions, and the sale of treasury stock.

QUESTION 306
In auditing a client's retained earnings account, an auditor should determine whether there are any restrictions on retained earnings that result from loans, agreements, or state law. This procedure is designed to corroborate management's financial statement assertions with respect to:

A. Transactions and events.
B. Account balances.
C. Presentation and disclosure.
D. Audit risk and materiality.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Restrictions on retained earnings should be shown as appropriations in the financial statements. An auditor attempts to determine whether any such restrictions exist to verify that proper disclosures (i.e., retained earnings appropriations) have been made.
Choices "a" and "b" are incorrect. Retained earnings appropriations restrict the company from paying dividends in excess of the unappropriated portion of retained earnings. This relates to presentation and disclosure, not to transactions, events, or balances.
Choice "d" is incorrect. Audit risk and materiality are not financial statement assertions.

QUESTION 307
Which of the following audit procedures is best for identifying unrecorded trade accounts payable?

A. Examining unusual relationships between monthly accounts payable balances and recorded cash payments.
B. Reconciling vendors' statements to the file of receiving reports to identify items received just prior to the balance sheet date.
C. Reviewing cash disbursements recorded subsequent to the balance sheet date to determine whether the related payables apply to the prior period.
D. Investigating payables recorded just prior to and just subsequent to the balance sheet date to determine whether they are supported by receiving reports.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Unrecorded trade accounts payable are best identified by reviewing cash disbursements recorded subsequent to the balance sheet date to determine whether the related payables apply to the prior period.
Choice "a" is incorrect. There is not usually a predictable relationship between accounts payable and cash payments, because management can pay cash or incur additional liabilities at its discretion.
Choice "b" is incorrect. Reconciling vendors' statements to the file of receiving reports would not identify unrecorded payables, as the vendor statement would still agree with the receiving report even if the payable were not recorded. Choice "d" is incorrect. Investigating payables already recorded would not help identify unrecorded trade payables.

QUESTION 308
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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. To determine whether checks are being issued for unauthorized expenditures, the auditor is most likely to select from the population of canceled checks. For each check, the auditor would then look for evidence supporting the payment, such as a purchase order, a receiving report, and an approved invoice.
Choice "a" is incorrect. If the auditor selected from the population of purchase orders, he or she would never find those check requests that were missing the purchase orders. Without purchase orders, the expenditures would be considered unauthorized.
Choice "c" is incorrect. If the auditor selected from the population of receiving reports, he or she would never find those check requests that were missing the receiving reports. Without receiving reports, the expenditures would be considered unauthorized.
Choice "d" is incorrect. If the auditor selected from the population of approved vouchers, he or she would never find those check requests that were missing the approved vouchers. Without approved vouchers, the expenditures would be considered unauthorized.

QUESTION 309
The primary purpose of sending a standard confirmation request to financial institutions with which the client has done business during the year is to:

A. Detect kiting activities that may otherwise not be discovered.
B. Corroborate information regarding deposit and loan balances.
C. Provide the data necessary to prepare a proof of cash.
D. Request information about contingent liabilities and secured transactions.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The primary purpose of sending a standard confirmation request to financial institutions is to corroborate information regarding deposit and loan balances.
Choice "a" is incorrect. The bank cut-off statement, not the standard bank confirmation form, is used to detect kiting activities that may otherwise not be discovered.
Choice "c" is incorrect. The standard confirmation does not provide all of the information necessary to prepare a proof of cash (i.e., bank reconciliation) since it only confirms information at the end of a period, and not activity (e.g., deposits, checks, etc.) occurring during the period.
Choice "d" is incorrect. The standard confirmation request seeks information on contingent liabilities and security agreements, but this is not the primary purpose of sending the confirmation.

QUESTION 310
To determine whether accounts payable are complete, an auditor performs a test to verify that all merchandise received is recorded. The population of documents for this test consists of all:

A. Payment vouchers.
B. Receiving reports.
C. Purchase requisitions.
D. Vendor's invoices.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. To determine whether accounts payable are complete, an auditor performs a test to verify that all merchandise received is recorded. This test consists of tracing from receiving reports for inventory received before yearend to the accounts payable trial balance to determine whether the purchase has been properly recorded.
Choice "a" is incorrect. In testing for completeness of payables, the auditor tries to determine whether there are payables that have not been recorded. If the auditor selects from payment vouchers, he or she may be unlikely to select an unrecorded payable, since unrecorded payables that have not yet been paid would not have corresponding payment vouchers.
Choice "c" is incorrect. Purchase requisitions do not indicate when the inventory was received, and therefore they are not useful for testing the completeness of accounts payable.
Choice "d" is incorrect. Vendor's invoices do not generally indicate when the inventory was received, and therefore they are not useful for testing the completeness of accounts payable.

QUESTION 311
Which of the following procedures would an auditor most likely perform in searching for unrecorded payables?

A. Reconcile receiving reports with related cash payments made just prior to year-end.
B. Contrast the ratio of accounts payable to purchases with the prior year's ratio.
C. Vouch a sample of creditor balances to supporting invoices, receiving reports, and purchase orders.
D. Compare cash payments occurring after the balance sheet date with the accounts payable trial balance.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. When performing a search for unrecorded payables, an auditor most likely would compare cash payments occurring after the balance sheet date with the accounts payable trial balance to determine that disbursements that pertain to the prior year's business (year under audit) have been properly accrued. This procedure is commonly known as an "out-of-period-search."
Choice "a" is incorrect. If the cash payment is made just prior to year-end, then the related liability would have been paid/relieved as of the year-end balance sheet date.
Choice "b" is incorrect. An analytical review procedure that contrasts the ratio of accounts payable to purchases with the prior year's ratio would not provide the best evidence, since payable balances are not predictable and may vary at management's discretion.
Choice "c" is incorrect. Vouching a sample of creditor balances already recorded does not provide any evidence concerning unrecorded payables.

QUESTION 312
Which of the following audit procedures is best for identifying unrecorded trade accounts payable?

A. Reviewing cash disbursements recorded subsequent to the balance sheet date to determine whether the related payables apply to the prior period.
B. Investigating payables recorded just prior to and just subsequent to the balance sheet date to determine whether they are supported by receiving reports.
C. Examining unusual relationships between monthly accounts payable balances and recorded cash payments.
D. Reconciling vendors' statements to the file of receiving reports to identify items received just prior to the balance sheet date.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. When performing a search for unrecorded payables, an auditor most likely would examine cash disbursements recorded after the balance

sheet date to determine whether the payables related to the prior period have been included in the accounts payable trial balance.
Choice "b" is incorrect. Investigating payables already recorded does not provide any evidence concerning unrecorded payables.
Choice "c" is incorrect. While a high level of cash payments compared with a low level of payable balances may be indicative of unrecorded payables, comparing these amounts would not be the most effective method for identifying unrecorded payables.
Choice "d" is incorrect. Comparing vendor statements to receiving reports is an audit step not involving the accounts payable balances; this step, therefore, provides no information about accounts payable.

QUESTION 313
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.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Proper authorization of write-offs of uncollectible accounts are approved by the treasurer, who is not involved in the record-keeping function or the initiation of the write-off. Choice "a" is incorrect. Proper segregation of duties requires that the authorization of the write-off be performed by individuals not involved with the accounts receivable department that records the original transactions.
Choice "b" is incorrect. The credit department should grant credit and approve credit limits before the sale is made. If the credit department also approved the write-offs of accounts, there would be a lack of appropriate segregation of duties. Choice "c" is incorrect. Even though the accounts payable department is independent of the accounts receivable department, they are not particularly knowledgeable regarding the customers and therefore would not be the best candidates for authorizing the write-offs of accounts receivable.

QUESTION 314
An auditor would consider a cashier's job description to contain compatible duties if the cashier receives remittances from the mailroom and also prepares the:

A. Prelist of individual checks.
B. Monthly bank reconciliation.
C. Daily deposit slip.
D. Remittance advices.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. An auditor would consider a cashier's job description to contain compatible duties if the cashier receives remittances from the mailroom and also prepares the daily deposit slip. (That is his or her job).
Choice "a" is incorrect. The prelist of individual checks is prepared by a clerk in the mailroom upon opening the mail.
Choice "b" is incorrect. The monthly bank reconciliation is prepared by an internal auditor or someone else that is independent of the cash receipts and cash disbursements functions. Choice "d" is incorrect. The remittance advice is prepared by the customer and is mailed along with the check (remittance).

QUESTION 315
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.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. If the objective of a test of details is to detect overstatements of sales (existence assertion), the auditor should trace transactions from the accounting records (i.e., sales journal) to the source documents (e.g., customer order, sales order, shipping documents, etc.).
Choices "a" and "c" are incorrect. Tracing from the supporting documents to the accounting records gives assurance as to the completeness assertion (all sales are properly included).
Choice "b" is incorrect. Tracing from the sales journal to the cash receipts journal only shows whether cash has been received for the sale. Failure to find a related cash receipt may indicate simply that the sale was made on account.

QUESTION 316
Which of the following procedures most likely would not be an internal control procedure designed to reduce the risk of errors 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.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Reconciling the control totals for sales invoices with the accounts receivable subsidiary ledger would probably not reduce the risk of errors in the billing process, since any errors in billing would likely be included in both the sales and accounts receivable balances.
Choice "a" is incorrect. Comparing control totals for shipping documents with corresponding totals for sales invoices is a procedure designed to determine that all shipments have been billed.
Choice "b" is incorrect. Using computer-programmed controls on sales invoices would reduce the risk of errors in the billing process.
Choice "c" is incorrect. Matching shipping documents with approved sales orders before invoice preparation provides assurance that the quantity and terms of the invoice are correct.

QUESTION 317
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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. An auditor should trace bank transfers for the last part of the audit period and first part of the subsequent period (bank transfer test) to detect whether cash balances were overstated because of kiting (concealing a cash shortage by depositing in one bank an unrecorded check of another

disbursement bank, effectively recording the same funds in both bank accounts).
Choice "a" is incorrect. If the cash receipts journal were held open for a few days after the year-end, cash receipts from the subsequent year would be erroneously included in the current year's accounting records. A bank transfer test is not typically used to detect this situation.
Choice "b" is incorrect. If the last checks recorded before the year-end were actually mailed by the yearend, appropriate cut-off has occurred. Bank transfer tests would not be required to evaluate this situation. Choice "d" is incorrect. A bank transfer test is not generally used to detect unusual payments to or receipts from related parties.

QUESTION 318
Which of the following most likely would be detected by an auditor's review of a client's sales cut-off?

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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. A sales cut-off test is used to detect unrecorded sales (shipments where no invoice has been generated) or sales allocated to the wrong period (January sales included in December by "holding the books open"). Choice "a" is incorrect. A sales cut-off test relies on shipping documents to test the "cut-off" of sales invoices. Shipping documents are selected and the corresponding sale is examined to determine whether it was recorded in the proper period. A cut-off test is unlikely to detect the omission of shipping documents, since transactions without such documentation would have no chance of being selected for testing. Choices "b" and "d" are incorrect. Sales cut-off testing generally does not involve tests related to accounts receivable.

QUESTION 319
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, 20X1. Assume all checks are dated and issued on December 30, 20X1.

Check No.	Bank Accounts From	Bank Accounts To
101	National	Federal
202	County	State
303	Federal	American
404	State	Republic

Check No.	Disbursement Date Per Books	Disbursement Date Per Bank	Receipt Date Per Books	Receipt Date Per Bank
101	Dec. 30	Jan. 4	Dec. 30	Jan. 3
202	Jan. 3	Jan. 2	Dec. 30	Dec. 31
303	Dec. 31	Jan. 3	Jan. 2	Jan. 2
404	Jan. 2	Jan. 2	Jan. 2	Dec. 31

Which of the following checks might indicate kiting?

A. #101 and #303.
B. #202 and #404.
C. #101 and #404.
D. #202 and #303.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Kiting is concealing a cash shortage by depositing in one bank an unrecorded check of another disbursement bank, so that the deposit is recorded in both banks. An auditor would most likely detect kiting by reviewing the bank transfer schedule and following-up on all transfers for which the receipt date per bank is recorded in the accounting period before the disbursement date.
Checks #202 and #404 both meet this criterion and therefore might indicate kiting. Choices "a", "c", and "d" are incorrect, based on the above .

QUESTION 320
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, 20X1. Assume all checks are dated and issued on December 30, 20X1.

Check	Bank Accounts	
No.	From	To
101	National	Federal
202	County	State
303	Federal	American
404	State	Republic

	Disbursement Date		Receipt Date	
Check No.	Per Books	Per Bank	Per Books	Per Bank
101	Dec. 30	Jan. 4	Dec. 30	Jan. 3
202	Jan. 3	Jan. 2	Dec. 30	Dec. 31
303	Dec. 31	Jan. 3	Jan. 2	Jan. 2
404	Jan. 2	Jan. 2	Jan. 2	Dec. 31

Which of the following checks illustrate deposits/transfers in transit at December 31, 20X1?

A. #101 and #202.
B. #101 and #303.
C. #202 and #404.
D. #303 and #404.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. A deposit in transit is a disbursement recorded in one accounting period with the receipt occurring in the subsequent period. Assuming all checks were dated and issued on December 30, 20X1, any deposits with a receipt date in 20X2 would indicate a deposit in transit at December 31, 20X1. Checks #101 and #303 both meet this criterion and therefore illustrate deposits/transfers in transit at December 31, 20X1. Choices "a", "c", and "d" are incorrect, based on the above .

QUESTION 321
Tracing bills of lading to sales invoices provides evidence that:

A. Shipments to customers were recorded as sales.
B. Recorded sales were shipped.
C. Invoiced sales were shipped.
D. Shipments to customers were invoiced.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Tracing from a population of bills of lading (shipping documents) to sales invoices provides evidence that shipments to customers were invoiced.
Choice "a" is incorrect. Tracing bills of lading to the sales invoice provides assurance that shipments to customers were invoiced, not that they were recorded as sales.
Choice "b" is incorrect. Tracing from the sales journal to bills of lading provides evidence that recorded sales were shipped.
Choice "c" is incorrect. Tracing from a population of sales invoices to the bills of lading provides evidence that invoiced sales were shipped.

QUESTION 322
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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Sales personnel will have a tendency to maximize sales volume by selling to customers that may not be creditworthy, thereby resulting in high bad debt write-offs. To prevent sales to customers that may not be creditworthy, employees involved in the credit-granting function are separated from the sales function.
Choice "a" is incorrect. Employees responsible for authorizing sales and bad debt write-offs should be denied access to cash to prevent the embezzlement of cash, not to prevent them from maximizing sales volume at the expense of high bad debt write-offs.
Choice "b" is incorrect. This control does not affect the sales department or the tendency to maximize sales volume at the expense of high bad debt write-offs.
Choice "d" is incorrect. This control does not affect the sales department or the tendency to maximize sales volume at the expense of high bad debt write-offs.

QUESTION 323
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.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Selecting prenumbered shipping documents and matching them with entries in the sales journal is a control that would help ensure that all credit sales transactions are recorded. (Shipping documents without corresponding sales journal entries might indicate unrecorded sales).
Choice "a" is incorrect. Sending copies of approved sales orders to the credit department for comparison to authorized credit limits and current account balances before the sale is made controls the risk of bad debts, not the proper recording of credit sales transactions.
Choice "b" is incorrect. Reconciling the accounts receivable subsidiary ledger to the control account ensures that the accounts receivable balance in the general ledger is properly recorded, but would not necessarily identify unrecorded credit sales. (Unrecorded credit sales would be omitted from both places, and therefore the subsidiary ledger and control account would still agree).
Choice "c" is incorrect. Controlling the mailing of monthly statements and investigating differences reported by the customers is not an effective control over the proper recording of credit sales transactions, since it is possible that customers would not complain if they were not billed.

QUESTION 324
An entity with a large volume of customer remittances by mail could most likely reduce the risk of employee misappropriation of cash by using:

A. Employee fidelity bonds.
B. Independently prepared mailroom prelists.
C. Daily check summaries.
D. A bank lockbox system.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. An entity with a large volume of customer remittances by mail could most likely reduce the risk of employee misappropriation of cash by using a bank lockbox system. With this system the remittances are mailed directly to the bank where they are immediately deposited. The bank sends the remittances and deposit detail to the entity on a daily basis. Most larger companies use a lockbox system.
Choice "a" is incorrect. Employee fidelity bonds may cover some of the losses suffered by misappropriation, but they do nothing to prevent the embezzlement in the first place.
Choices "b" and "c" are incorrect. Independently prepared mailroom prelists and daily check summaries are good controls over cash receipts, but they are not as effective at reducing the risk of employee misappropriation as a lockbox system. With a lockbox system, employees have no access to cash receipts and therefore no opportunity to misappropriate cash.

QUESTION 325
Which of the following internal control procedures most likely would deter lapping of collections from customers?

A. Independent internal verification of dates of entry in the cash receipts journal with dates of daily cash summaries.
B. Authorization of write-offs of uncollectible accounts by a supervisor independent of credit approval.

C. Segregation of duties between receiving cash and posting the accounts receivable ledger.
D. Supervisory comparison of the daily cash summary with the sum of the cash receipts journal entries.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Lapping is a defalcation in which a cash shortage is concealed by applying later customer remittances to a receivable account from which money was stolen. Lapping can be deterred by appropriate segregation of duties between receiving cash and posting to the accounts receivable ledger.
This makes it more difficult for the employee who is stealing the cash to cover it up through inappropriate remittance credits.
Choice "a" is incorrect. Even with a lapping scheme, the dates of cash receipts journal entries and the dates of daily cash summaries would still agree, since the stolen funds would be excluded from both places and subsequent receipts would be included in both places.
Choice "b" is incorrect. The authorization of write-offs of uncollectible accounts by a supervisor independent of credit approval would not deter lapping, since lapping schemes do not involve write-offs.
Choice "d" is incorrect. Even with a lapping scheme, the daily cash summary would still agree with the sum of the cash receipts journal entries. Stolen funds would be excluded from both places and subsequent receipts would be included in both places.

QUESTION 326
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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Tracing from shipping documents (source documents) to sales invoices provides evidence that shipments to customers are properly invoiced.

Choice "a" is incorrect. Tracing shipping documents to sales invoices wouldn't necessarily identify duplicate shipments or billings. Duplicate shipments or billings could be identified by accounting for prenumbered shipping documents and sales invoices.
Choice "c" is incorrect. The auditor would compare the signed purchase order to shipping documents to determine if all goods ordered by the customer were shipped.
Choice "d" is incorrect. To determine that all prenumbered sales invoices were accounted for, an auditor would review the consecutive numbering of invoices and then trace from the sales invoices into the sales journal.

QUESTION 327
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 the 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.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Observing the consistent use of cash registers and tapes by employees would provide evidence to the auditor regarding the controls over the completeness of cash receipts.
Choices "b", "c", and "d" are incorrect. The completeness assertion relates to the recording of all transactions. Inquiries about access to recorded cash, tracing from the cash receipts journal, and testing the general ledger balance do not provide evidence regarding possible unrecorded transactions.

QUESTION 328
For effective internal accounting control, the accounts payable department should compare the information on each vendor's invoice with the:

A. Receiving report and the purchase order.
B. Receiving report and the voucher.
C. Vendor's packing slip and the purchase order.
D. Vendor's packing slip and the voucher.

Correct Answer: A
Section: Volume E

Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. For effective internal accounting control, the accounts payable department should compare the information on each vendor's invoice with the receiving report and the purchase order to assure that goods were received and that the purchase was properly authorized.
Choices "b", "c", and "d" are incorrect. Vendor packing slips and internally generated vouchers do not provide assurance that goods were received and that the purchase was properly authorized.

QUESTION 329
Which of the following is the most effective control activity to detect vouchers that were prepared for the payment of goods that were not received?

A. Count goods upon receipt in storeroom.
B. Match purchase order, receiving report, and vendor's invoice for each voucher in accounts payable department.
C. Compare goods received with goods requisitioned in receiving department.
D. Verify vouchers for accuracy and approval in internal audit department.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The most effective control activity to detect vouchers that were prepared for the payment of goods that were not received is to match the purchase order, receiving report, and vendor's invoice for each voucher in the accounts payable department.
Choices "a" and "c" are incorrect. Controls that start with goods received would not be effective at detecting a situation where vouchers are prepared for goods that were not received.
Choice "d" is incorrect. Verifying vouchers for accuracy and approval in the internal audit department might detect vouchers that were prepared for the payment of goods that were not received. However, this is not the most effective control, since it would likely occur subsequent to the processing of the transaction.

QUESTION 330
For effective internal control purposes, the vouchers 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.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. For effective internal control purposes, the vouchers payable department generally should establish the agreement of the vendor's invoice with the receiving report and purchase order. Choice "a" is incorrect. The treasury or cash disbursement department should stamp, perforate, or otherwise cancel supporting documentation after payment is mailed.
Choice "b" is incorrect. The purchasing department should verify that each requisition has been properly approved.
Choice "c" is incorrect. The purchasing department should obliterate the "quantity ordered" on the receiving department copy of the purchase order.

QUESTION 331
To determine whether accounts payable are complete, an auditor performs a test to verify that all merchandise received is recorded. The population of documents for this test consists of all:

A. Vendor's invoices.
B. Purchase orders.
C. Receiving reports.
D. Canceled checks.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. The auditor is looking for situations where merchandise has been received but was not recorded. Such situations may be identified by selecting receiving reports and then determining whether the related payable was recorded.
Choice "a" is incorrect. Selecting from vendor's invoices might allow a purchase to be selected for which the goods have not yet been received.
Choice "b" is incorrect. Selecting from purchase orders might allow a purchase to be selected for which the goods have not yet been received.
Choice "d" is incorrect. Selecting from canceled checks will not result in testing of accounts payable, since the payable is eliminated once payment is made.

QUESTION 332
Which of the following control activities is not usually performed in the vouchers payable department?

A. Determining the mathematical accuracy of the vendor's invoice.
B. Having an authorized person approve the voucher.
C. Controlling the mailing of the check and remittance advice.
D. Matching the receiving report with the purchase order.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Internal control is enhanced if check mailing is performed by the treasury (cash disbursements) department.
Choice "a" is incorrect. Mathematical accuracy of the vendor's invoice is usually verified in the vouchers payable department.
Choice "b" is incorrect. Voucher approval by an authorized person is usually performed in the vouchers payable department.
Choice "d" is incorrect. Matching the receiving report with the purchase order is usually performed in the vouchers payable department.

QUESTION 333
Which of the following internal control procedures 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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. The internal control procedure of prenumbering receiving reports and periodically reconciling them to the inventory records most likely

addresses the completeness assertion for inventory, because it allows the auditor to determine whether all goods received have been recorded as inventory.
Choice "a" is incorrect. Reconciling the work in process account (per the general ledger) with subsidiary records (direct materials, direct labor, overhead) tests that those records are interfacing properly, but does not provide any information about the completeness assertion for inventory.
Choice "b" is incorrect. Separation of employees responsible for custody of finished goods from the receiving function addresses the safeguarding of assets, not the completeness of the inventory records. Choice "d" is incorrect. The separation of duties between the payroll department and inventory accounting personnel is related to the valuation (pricing) of inventory, not its completeness.

QUESTION 334
Which of the following controls would be most effective in assuring that recorded purchases are free of material errors?

A. The receiving department compares the quantity ordered on purchase orders with the quantity received on receiving reports.
B. Vendor's invoices are compared with purchase orders by an employee who is independent of the receiving department.
C. Receiving reports require the signature of the individual who authorized the purchase.
D. Purchase orders, receiving reports, and vendor's invoices are independently matched in preparing vouchers.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The most effective control in assuring that recorded purchases are free of material errors is the independent matching of the purchase order, receiving report, and vendor's invoices in preparing the vouchers on which the disbursement check is based.
Choice "a" is incorrect. The receiving department should not have access to the quantity ordered on the purchase order. This forces receiving department employees to actually perform an independent count.
Choice "b" is incorrect. It is not enough to compare only vendor invoices and purchase orders, as this will still allow payment for goods that were not received.
Choice "c" is incorrect. Requiring that receiving reports be authorized by the individual who authorized the purchase does not ensure that the invoice and the related payment will be properly recorded.

QUESTION 335
Mailing disbursement checks and remittance advices should be controlled by the employee who:

A. Approves the vouchers for payment.
B. Matches the receiving reports, purchase orders, and vendor's invoices.
C. Maintains possession of the mechanical check-signing device.
D. Signs the checks last.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Mailing disbursement checks and remittance advices should be controlled by the employee who signs the check last. This employee is generally in the treasury department.
Choices "a" and "b" are incorrect. Approving the vouchers for payment and matching the receiving report, purchase orders, and vendor's invoices are functions of the vouchers payable department.
Choice "c" is incorrect. When a mechanical check-signing device is used, there is generally dual control. One person maintains possession of the device itself, and the other controls the signature plates. The person with possession of the device would not mail disbursement checks, since mailing should be done by the last check signer.

QUESTION 336
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?

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. A question-related to whether purchase orders, receiving reports and vouchers are prenumbered and periodically accounted for would most likely be included in an internal control questionnaire concerning the completeness assertion for purchases. A gap in recorded purchase order numbers might indicate an unrecorded purchase.
Choice "a" is incorrect. Requiring an authorized purchase order before accepting a shipment would relate to whether the purchase was valid, not whether it was properly accounted for.
Choice "b" is incorrect. Having prenumbered purchase requisitions independently matched with vendor invoices does not indicate whether all purchases are accounted for since these documents do not show that the purchase has been recorded.
Choice "c" is incorrect. Reconciling the unpaid voucher file with inventory records does not indicate whether all purchases are accounted for since these

documents do not show that all purchases have been recorded.

QUESTION 337
When the shipping department returns nonconforming goods to a vendor, the purchasing department should send to the accounting department the:

A. Unpaid voucher.
B. Debit memo.
C. Vendor invoice.
D. Credit memo.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. When nonconforming goods are returned to a vendor, the purchasing department should send a debit memo to the accounting department to ensure that the accounts payable balance is reduced appropriately. Choice "a" is incorrect. The unpaid voucher is sent from the accounts payable department to the treasurer's department for payment when conforming goods are received. Choice "c" is incorrect. The vendor invoice is sent to the accounting department when conforming goods are received. Choice "d" is incorrect. A credit memo is generally used to reduce accounts receivable, not accounts payable.

QUESTION 338
The authority to accept incoming goods in receiving should be based on a (an):

A. Vendor's invoice.
B. Materials requisition.
C. Bill of lading.
D. Approved purchase order.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The authority to accept incoming goods in receiving should be based upon an approved purchase order.
Choice "a" is incorrect. A vendor's invoice does not serve as an authority to accept incoming goods since it is generated by the vendor, not a responsible employee in the purchasing department.
Choice "b" is incorrect. A materials requisition, which is prepared by the ultimate user of the goods, does not serve as an authority to accept incoming goods since it has not been approved by the purchasing department. Choice "c" is incorrect. A bill of lading does not serve as an authority to accept incoming goods since it is generated by the carrier, not a responsible employee in the purchasing department.

QUESTION 339
In a 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.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. In a well designed internal control, employees in the purchasing department most likely would approve purchase orders and also negotiate terms with vendors.
Choice "a" is incorrect. Personnel in the accounts payable department reconcile the open invoice file while the purchasing agent approves purchase orders.
Choice "b" is incorrect. Employees in the receiving department inspect goods upon receipt while the purchasing agent approves purchase orders.
Choice "c" is incorrect. The stores department (personnel in the raw materials inventory area) authorize requisition of goods while the purchasing agent approves purchase orders.

QUESTION 340
An auditor's purpose in reviewing credit ratings of customers with delinquent accounts receivable most likely is to obtain evidence concerning management's assertions about:

A. Understandability and classification.
B. Existence.
C. Rights and obligations.
D. Valuation and allocation.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. An auditor's purpose in reviewing credit ratings of customers with delinquent accounts receivable most likely is to obtain evidence concerning management's assertions about valuation or allocation, which pertain to the presentation of assets, liabilities, and equity interests at appropriate amounts. The auditor is concerned with the proper valuation of those receivables.
Choice "a" is incorrect. Understandability and classification deals with whether the components of the financial statements are properly presented, described, and disclosed, not whether they are properly valued. Choice "b" is incorrect. Existence relates to whether assets, liabilities, and equity interests exist.
Choice "c" is incorrect. Rights and obligations pertain to ownership of assets and liabilities, not to the valuation of those accounts.

QUESTION 341
An auditor most likely would review an entity's periodic accounting for the numerical sequence of shipping documents and invoices to support management's financial statement assertion of:

A. Occurrence.
B. Classification.
C. Cutoff.
D. Completeness.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. An entity's periodic accounting for the numerical sequence of shipping documents and invoices supports management's financial statement assertion of completeness of sales. A gap in recorded sequence numbers might indicate an unrecorded sale.
Choice "a" is incorrect. An auditor would trace from the sales invoices or sales journal (accounting records) to the shipping documents (source document) to support management's assertion of occurrence.
Choice "b" is incorrect. An auditor would examine journal entries for a sample of shipping documents to determine whether the client has recorded the sales in the proper accounts.
Choice "c" is incorrect. An auditor would review supporting documentation for shipping documents just before and just after year-end to determine whether appropriate cutoff has been achieved.

QUESTION 342
In evaluating the adequacy of the allowance for doubtful accounts, an auditor most likely reviews the entity's aging of receivables to support management's financial statement assertion of:

A. Existence.
B. Valuation and allocation.
C. Completeness.
D. Rights and obligations.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. In evaluating the adequacy of the allowance for doubtful accounts, an auditor most likely reviews the entity's aging of receivables to support the assertion of valuation and allocation (i.e., to determine whether the allowance for doubtful accounts properly adjusts the receivables balance to net realizable value).
Choice "a" is incorrect. Evaluating the adequacy of the allowance for doubtful accounts does not pertain to existence. To support the assertion of existence, an auditor would most likely confirm accounts receivable.
Choice "c" is incorrect. An auditor would trace from shipping records to the sales journal and the accounts receivable ledger to determine if all shipments were properly recorded as sales (completeness assertion).
Choice "d" is incorrect. The assertion of rights and obligations relating to accounts receivable would be supported by examining appropriate supporting documentation, not by evaluating the allowance for doubtful accounts.

QUESTION 343
Symbol A most likely represents:

A. Remittance advice file.
B. Receiving report file.
C. Accounts receivable master file.
D. Cash disbursements transaction file.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. The accounts receivable master file is the file most likely to be affected by sales and cash receipts transactions, as noted immediately above symbol "A" in the flowchart. Choice "a" is incorrect. Remittance advices are used to update the accounts receivable file, but a separate "remittance advice file" generally is not created. Choice "b" is incorrect. The inventory/purchase/cash disbursements cycle would include a receiving report file, not the revenue cycle. Choice "d" is incorrect. Cash disbursements are not part of the revenue cycle.

QUESTION 344
Symbol B most likely represents:

A. Customer orders.
B. Receiving reports.
C. Customer checks.
D. Sales invoices.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The two documents most likely to be generated by the revenue cycle application are credit memos (already identified in the flowchart) and sales invoices.
Choice "a" is incorrect. Customer orders are input at the beginning of the process, as noted in the flowchart. Customer orders are not generated by the company's revenue cycle.
Choice "b" is incorrect. Receiving reports are part of the inventory/purchasing/cash disbursements cycle.
Choice "c" is incorrect. Customer checks and remittances are entered into the application at the top of the flowchart. Customer checks are not an output of the revenue cycle.

QUESTION 345
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one source for each item.
During our audit we discovered evidence of the company's failure to safeguard inventory from loss, damage, and misappropriation.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "B" is correct. Failure to safeguard inventory from loss, damage, and misappropriation is a significant deficiency in the design or operation of internal control that could adversely affect the fairness of the financial statements.

QUESTION 346
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one source for each item.
The company considers the decline in value of equity securities classified as available-for-sale to be temporary.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.

C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: N
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "N" is correct. Management's discussion regarding the temporary nature of a decline in the value of equity securities provides information regarding recognition, measurement, and disclosure, and would be included in the management representation letter.

QUESTION 347
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.
Select, as the best answer for each item, the most likely source. Select only one source for each item.
Was the difference of opinion on the accrued pension liabilities that existed between the engagement personnel and the actuarial specialist resolved in accordance with firm policy and appropriately documented?

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.

E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: M
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "M" is correct. The engagement partner has ultimate responsibility for the performance of the audit and the preparation of the report. He or she would therefore want to ensure that any differences of opinion between engagement personnel and a specialist were resolved in accordance with firm policy and were appropriately documented.

QUESTION 348
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one source for each item.
Our audit is designed to provide reasonable assurance of detecting misstatements that, in our judgment, could have a material effect on the financial statements taken as a whole. Consequently, our audit will not necessarily detect all misstatements that exist due to error, fraudulent financial reporting, or misappropriation of assets.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.

F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: H
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "H" is correct. An understanding with the client should be established, and this understanding should be documented through an engagement letter. The understanding, and the letter, should include the auditor's responsibilities, including the fact that an audit is designed to provide only reasonable assurance of detecting material misstatements, and therefore may not necessarily detect all misstatements that exist.

QUESTION 349
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one source for each item.
There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.

H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: N
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "N" is correct. Management's statement that there have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices provides information regarding the completeness of information, and would be included in the management representation letter.

QUESTION 350
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.
Select, as the best answer for each item, the most likely source. Select only one source for each item.
Nothing came to our attention that caused us to believe that at October 31, 20XX, there was any change in the capital stock, increase in long-term debt, or decrease in consolidated net current assets or stockholders' equity as compared with the amounts shown in the September 30, 20XX unaudited condensed consolidated balance sheet.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.

H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: I
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "I" is correct. In a comfort letter, negative assurance is provided with respect to changes in selected financial statement items during a period subsequent to the date and period of the latest financial statements included in the registration statement.

QUESTION 351
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one source for each item. It is our opinion that the possible liability to the company in this proceeding is nominal in amount.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.

K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "D" is correct. In response to an audit inquiry letter, a lawyer would provide corroboration regarding the likelihood of an unfavorable outcome to pending litigation and an estimate of any potential loss.

QUESTION 352
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.
Select, as the best answer for each item, the most likely source. Select only one source for each item.
As discussed in Note 4 to the financial statements, the company experienced a net loss for the year ended July 31, 20XX, and is currently in default under substantially all of its debt agreements. In addition, on September 25, 20XX, the company filed a prenegotiated voluntary petition for relief under Chapter 11 of the U.S. Bankruptcy Code. These matters raise substantial doubt about the company's ability to continue as a going concern.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.

L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: L
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "L" is correct. When there is substantial doubt about an entity's ability to continue as a going concern, the auditor would state his or her concerns in an explanatory paragraph of the auditor's report.

QUESTION 353
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.
Select, as the best answer for each item, the most likely source. Select only one source for each item.
During the year under audit, we were advised that management consulted with Better & Best, CPAs. The purpose of this consultation was to obtain another CPA firm's opinion concerning the company's recognition of certain revenue that we believe should be deferred to future periods. Better & Best's opinion was consistent with our opinion, so management did not recognize the revenue in the current year.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.

M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: F
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "F" is correct. Unless all of those charged with governance are also involved with managing the entity, the auditor should discuss with those charged with governance significant accounting or auditing matters that were the subject of outside consultation.

QUESTION 354
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one source for each item.
The company believes that all material expenditures that have been deferred to future periods will be recoverable.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.

P. Predecessor auditor's communication with successor auditor.

Correct Answer: N
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "N" is correct. Management's discussion of its belief that all material expenditures that have been deferred to future periods will be recoverable provides information regarding recognition, measurement, and disclosure, and would be included in the management representation letter.

QUESTION 355
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.
Select, as the best answer for each item, the most likely source. Select only one source for each item.
Our use of professional judgment and the assessment of audit risk and materiality for the purpose of our audit mean that matters may have existed that would have been assessed differently by you. We make no representation as to the sufficiency or appropriateness of the information in our audit documentation for your purposes.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: P
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "P" is correct. An audit of a new client may be facilitated by review of the predecessor's audit documentation. The predecessor should make it clear that they are not responsible for the sufficiency or appropriateness of the information in their audit documentation for the successor auditor's purposes.

QUESTION 356
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.
Select, as the best answer for each item, the most likely source. Select only one source for each item.
Indicate in the space provided below whether this information agrees with your records. If there are exceptions, please provide any information that will assist the auditor in reconciling the difference.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: J
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "J" is correct. Receivable confirmations request customers of the client to confirm balances and identify discrepancies.

QUESTION 357
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.
Select, as the best answer for each item, the most likely source. Select only one source for each item.
Blank checks are maintained in an unlocked cabinet along with the check-signing machine. Blank checks and the check-signing machine should be locked in separate locations to prevent the embezzlement of funds.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "B" is correct. Failure to lock blank checks and the check-signing machine in separate locations is a significant deficiency in the design or operation of internal control that could adversely affect the fairness of the financial statements.

QUESTION 358
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.
Select, as the best answer for each item, the most likely source. Select only one source for each item.
Our audit cannot be relied upon to disclose significant deficiencies in the design or operation of internal control. Nevertheless, we will communicate to you all such significant deficiencies and potential areas for improvement that we become aware of during the course of our audit.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: H
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "H" is correct. An understanding with the client should be established, and this understanding should be documented through an engagement letter. The understanding, and the letter, should include limitations of the engagement, including the fact that an audit is not designed to provide assurance on internal control or to identify significant deficiencies in internal control.

QUESTION 359
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.
Select, as the best answer for each item, the most likely source. Select only one source for each item.
The timetable set by management to complete our audit was unreasonable considering the failure of the company's personnel to complete schedules on a timely basis and delays in providing necessary information.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: F
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "F" is correct. The auditor should inform the audit committee of any serious difficulties encountered with management during the performance of the audit.

QUESTION 360

This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.
Select, as the best answer for each item, the most likely source. Select only one source for each item.
Several employees have disabled the anti-virus detection software on their PCs because the software slows the processing of data and occasionally rings false alarms. The company should obtain anti-virus software that runs continuously at all system entry points and that cannot be disabled by unauthorized personnel.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "B" is correct. The ability for unauthorized personnel to disable anti-virus detection software is a significant deficiency in the design or operation of internal control that could adversely affect the fairness of the financial statements.

QUESTION 361
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one

source for each item.
In connection with an audit of our financial statements, management has prepared, and furnished to our auditors, a description and evaluation of certain contingencies.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "C" is correct. In an audit inquiry letter to legal counsel, management states that they have furnished to the auditors a description and evaluation of pending or threatened litigation and unasserted claims and assessments.

QUESTION 362
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one source for each item.
The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.
C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: N
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "N" is correct. Management's discussion of plans or intentions that may materially affect the carrying value or classification of assets and liabilities provides information regarding recognition, measurement, and disclosure, and would be included in the management representation letter.

QUESTION 363
This question-will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one source for each item.
In planning the sampling application, was appropriate consideration given to the relationship of the sample to the audit objective and to preliminary judgments about materiality levels?

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.
B. Auditor's communications on significant deficiencies in internal control.

C. Audit inquiry letter to legal counsel.
D. Lawyer's response to audit inquiry letter.
E. Communication from those charged with governance to the auditor.
F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).
G. Report on the application of accounting principles.
H. Auditor's engagement letter.
I. Letter for underwriters.
J. Accounts receivable confirmation request.
K. Request for bank cutoff statement.
L. Explanatory paragraph of an auditor's report on financial statements.
M. Partner's engagement review notes.
N. Management representation letter.
O. Successor auditor's communication with predecessor auditor.
P. Predecessor auditor's communication with successor auditor.

Correct Answer: M
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "M" is correct. The engagement partner has ultimate responsibility for the performance of the audit and the preparation of the report. He or she would therefore want to ensure that, in planning a sampling application, appropriate consideration was given to the relationship of the sample to the audit objective and to preliminary judgments about materiality levels.

QUESTION 364
An auditor discovered that a client's accounts receivable turnover is substantially lower for the current year than for the prior year. This may indicate that:

A. Obsolete inventory has not yet been reduced to fair market value.
B. There was an improper cutoff of sales at the end of the year.
C. An unusually large receivable was written off near the end of the year.
D. The aging of accounts receivable was improperly performed in both years.

Correct Answer: B
Section: Volume E

Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Accounts receivable turnover is calculated as sales / receivables. A decline in this ratio may indicate that there was an improper cutoff of sales at the end of the year. For example, if sales made at the beginning of the subsequent year were inadvertently recorded in the current year, both sales and receivables would be overstated by the same amount. This would generally result in a larger proportionate effect on receivables (since the receivables balance is smaller than sales for the year), and an overall decrease in the ratio.
Choice "a" is incorrect. Failure to write down obsolete inventory would not affect sales or receivables, and so would have no effect on accounts receivable turnover.
Choice "c" is incorrect. Write-off of an unusually large receivable would reduce the receivables balance without affecting sales. This in turn would cause an increase in accounts receivable turnover. Choice "d" is incorrect. The aging of accounts receivable does not affect the overall receivable balance, and therefore would have no effect on accounts receivable turnover.

QUESTION 365
To obtain assurance that all inventory items in a client's inventory listing are valid, an auditor most likely would trace:

A. Inventory tags noted during the auditor's observation to items listed in receiving reports and vendors' invoices.
B. Items listed in receiving reports and vendors' invoices to the inventory listing.
C. Inventory tags noted during the auditor's observation to items in the inventory listing.
D. Items in the inventory listing to inventory tags and the auditor's recorded count sheets.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Tracing from the inventory listing to the inventory tags and the auditor's recorded count sheets verifies the validity (existence) of the items.
Choice "a" is incorrect. Tracing inventory tags noted during the auditor's observation to items listed in receiving reports and vendors' invoices might be used to verify completeness of purchases or payables.
Choice "b" is incorrect. Tracing from receiving reports and vendors' invoices to the inventory listing are cut-off procedures used to verify completeness of the inventory listing. Choice "c" is incorrect. Tracing from inventory tags to the inventory listing schedule verifies the completeness of the schedule, not the existence (or validity) of the items.

QUESTION 366

An audit partner is developing an office training program to familiarize his professional staff with statistical decision models applicable to the audit of dollar value balances. He wishes to demonstrate the relationship of sample sizes to population size and variability and the auditor's specifications as to tolerable misstatement and risk of incorrect acceptance. The partner prepared the following table to show comparative population characteristics and audit specifications of two populations.

	Characteristics of Population 1 Relative to Population 2		Audit Specifications as to a Sample from Population 1 Relative to a Sample from Population 2	
	Size	Variability	Specified Tolerable Misstatement	Specified Risk of Incorrect Acceptance
Case 1	Equal	Equal	Equal	Lower
Case 2	Equal	Larger	Larger	Equal
Case 3	Larger	Equal	Smaller	Higher
Case 4	Smaller	Smaller	Equal	Higher
Case 5	Larger	Equal	Equal	Lower

You are to indicate for the specified case from the above table the required sample size to be selected from population 1 relative to the sample from population 2. In case 1 the required sample size from population 1 is:

A. Larger than the required sample size from population 2.
B. Equal to the required sample size from population 2.
C. Smaller than the required sample size from population 2.
D. Indeterminate relative to the required sample size from population 2.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. A lower risk of incorrect acceptance requires a greater sample size. Choices "b", "c", and "d" are incorrect, based on the above .

QUESTION 367

An audit partner is developing an office training program to familiarize his professional staff with statistical decision models applicable to the audit of dollar value balances. He wishes to demonstrate the relationship of sample sizes to population size and variability and the auditor's specifications as to tolerable misstatement and risk of incorrect acceptance. The partner prepared the following table to show comparative population characteristics and audit specifications of two populations.

	Characteristics of Population 1 Relative to Population 2		Audit Specifications as to a Sample from Population 1 Relative to a Sample from Population 2	
	Size	Variability	Specified Tolerable Misstatement	Specified Risk of Incorrect Acceptance
Case 1	Equal	Equal	Equal	Lower
Case 2	Equal	Larger	Larger	Equal
Case 3	Larger	Equal	Smaller	Higher
Case 4	Smaller	Smaller	Equal	Higher
Case 5	Larger	Equal	Equal	Lower

You are to indicate for the specified case from the above table the required sample size to be selected from population 1 relative to the sample from population 2. In case 2 the required sample size from population 1 is:

A. Larger than the required sample size from population 2.
B. Equal to the required sample size from population 2.
C. Smaller than the required sample size from population 2.
D. Indeterminate relative to the required sample size from population 2.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The effect on sample size cannot be determined, because there is more than one change occurring. In this case, the increase in population variability results in an increase in sample size, whereas the larger tolerable misstatement results in a decrease in sample size. The overall effect on sample size will depend on which of the two effects is greater, but this cannot be determined from the information provided. Choices "a", "b", and "c" are incorrect, based on the above .

QUESTION 368
An audit partner is developing an office training program to familiarize his professional staff with statistical decision models applicable to the audit of dollar value balances. He wishes to demonstrate the relationship of sample sizes to population size and variability and the auditor's specifications as to tolerable misstatement and risk of incorrect acceptance. The partner prepared the following table to show comparative population characteristics and audit specifications of two populations.

	Characteristics of Population 1 Relative to Population 2		*Audit Specifications as to a Sample from Population 1 Relative to a Sample from Population 2*	
	Size	*Variability*	*Specified Tolerable Misstatement*	*Specified Risk of Incorrect Acceptance*
Case 1	Equal	Equal	Equal	Lower
Case 2	Equal	Larger	Larger	Equal
Case 3	Larger	Equal	Smaller	Higher
Case 4	Smaller	Smaller	Equal	Higher
Case 5	Larger	Equal	Equal	Lower

You are to indicate for the specified case from the above table the required sample size to be selected from population 1 relative to the sample from population 2. In case 3 the required sample size from population 1 is:

A. Larger than the required sample size from population 2.
B. Equal to the required sample size from population 2.
C. Smaller than the required sample size from population 2.
D. Indeterminate relative to the required sample size from population 2.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The effect on sample size cannot be determined, because there is more than one change occurring. In this case, the smaller tolerable misstatement results in an increase in sample size, but the higher risk of incorrect acceptance results in a decrease in sample size. The overall effect on sample size will depend on which of the two effects is greater, but this cannot be determined from the information provided. Note that the number of items in the population is generally assumed to have virtually no effect on sample size. Choices "a", "b", and "c" are incorrect, based on the above .

QUESTION 369
An audit partner is developing an office training program to familiarize his professional staff with statistical decision models applicable to the audit of dollar value balances. He wishes to demonstrate the relationship of sample sizes to population size and variability and the auditor's specifications as to tolerable misstatement and risk of incorrect acceptance. The partner prepared the following table to show comparative population characteristics and audit specifications of two populations.

	Characteristics of Population 1 Relative to Population 2		Audit Specifications as to a Sample from Population 1 Relative to a Sample from Population 2	
	Size	Variability	Specified Tolerable Misstatement	Specified Risk of Incorrect Acceptance
Case 1	Equal	Equal	Equal	Lower
Case 2	Equal	Larger	Larger	Equal
Case 3	Larger	Equal	Smaller	Higher
Case 4	Smaller	Smaller	Equal	Higher
Case 5	Larger	Equal	Equal	Lower

You are to indicate for the specified case from the above table the required sample size to be selected from population 1 relative to the sample from population 2. In case 4 the required sample size from population 1 is:

A. Larger than the required sample size from population 2.
B. Equal to the required sample size from population 2.
C. Smaller than the required sample size from population 2.
D. Indeterminate relative to the required sample size from population 2.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. There are two changes occurring, but they both have the same effect on sample size. A decrease in population variability and an increase in the risk of incorrect acceptance both result in a decrease in the required sample size. Note that the number of items in the population is generally assumed to have virtually no effect on sample size. Choices "a", "b", and "d" are incorrect, based on the above .

QUESTION 370

An audit partner is developing an office training program to familiarize his professional staff with statistical decision models applicable to the audit of dollar value balances. He wishes to demonstrate the relationship of sample sizes to population size and variability and the auditor's specifications as to tolerable misstatement and risk of incorrect acceptance. The partner prepared the following table to show comparative population characteristics and audit specifications of two populations.

	Characteristics of Population 1 Relative to Population 2		Audit Specifications as to a Sample from Population 1 Relative to a Sample from Population 2	
	Size	Variability	Specified Tolerable Misstatement	Specified Risk of Incorrect Acceptance
Case 1	Equal	Equal	Equal	Lower
Case 2	Equal	Larger	Larger	Equal
Case 3	Larger	Equal	Smaller	Higher
Case 4	Smaller	Smaller	Equal	Higher
Case 5	Larger	Equal	Equal	Lower

You are to indicate for the specified case from the above table the required sample size to be selected from population 1 relative to the sample from population 2. In case 5 the required sample size from population 1 is:

A. Larger than the required sample size from population 2.
B. Equal to the required sample size from population 2.
C. Smaller than the required sample size from population 2.
D. Indeterminate relative to the required sample size from population 2.

Correct Answer: A

Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. A lower risk of incorrect acceptance results in an increase in sample size. Note that the number of items in the population is generally assumed to have virtually no effect on sample size. Choices "b", "c", and "d" are incorrect, based on the above .

QUESTION 371
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:

A. 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.
B. There is an unacceptably high risk that the tolerable misstatement exceeds the sum of actual overstatements and understatements.
C. The asset account is fairly stated because the total projected misstatement is less than the tolerable misstatement.
D. The asset account is fairly stated because the tolerable misstatement exceeds the net of projected actual overstatements and understatements.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Selection of every twentieth item results in a sample that is 5% (1/20 = .05) of the population. The sample results indicate a net overstatement of $3,500 (= $3,700 âˆ’ $200), which is then projected to the total population as $70,000 (= $3,500 / .05). (Alternatively, 3,500 Ã— 20 = 70,000). Since the projected misstatement of $70,000 exceeds the tolerable misstatement of $60,000, there is an unacceptably high risk that the actual misstatement in the population will exceed the tolerable misstatement.
Choice "b" is incorrect. Tolerable misstatement is compared to the projected misstatement, not to the actual error in the sample.
Choices "c" and "d" are incorrect. The asset account is not fairly stated because the projected misstatement exceeds the tolerable misstatement.

QUESTION 372
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. The sample size in an attribute sampling application is affected by the allowable risk of assessing control risk too low, the tolerable deviation rate, and the expected deviation rate. The average dollar value of the check requests has no effect on the sample size.
Choices "a", "b", and "d" are incorrect, per the above .

QUESTION 373
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

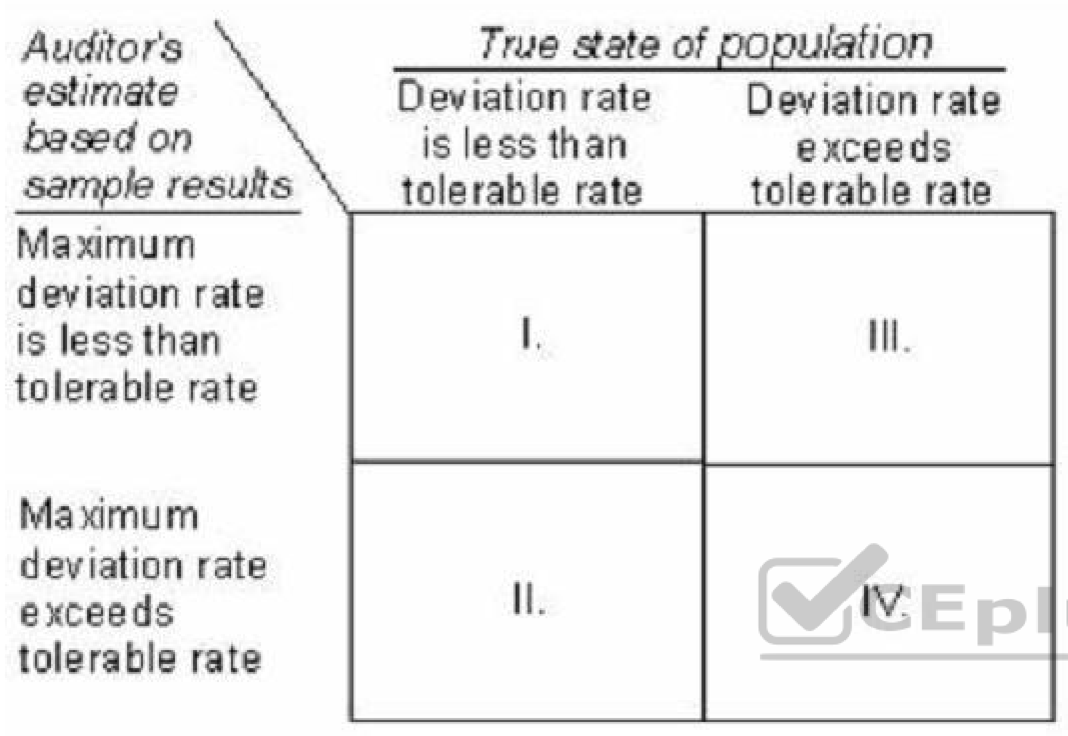
A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The sample size in a variables sampling application is affected by the variability in the population (generally represented by the standard deviation), the acceptable level of risk (i.e., the risk of incorrect acceptance), the tolerable misstatement, and the expected misstatement.
Choices "b", "c", and "d" are incorrect, per the above .

QUESTION 374
The diagram below depicts an auditor's estimated maximum deviation rate compared with the tolerable rate, and also depicts the true population deviation rate compared with the tolerable rate.



As a result of tests of controls, the auditor assesses control risk too low and thereby decreases substantive testing. This is illustrated by situation:

A. I.
B. II.
C. III.
D. IV.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. If the auditor assesses control risk too low, then the true population deviation rate exceeds the auditor's tolerable rate while the auditor's estimate of the maximum deviation rate (based on sample results) was less than the tolerable rate. Only cell III represents this set of conditions. Choices "a", "b", and "d" are incorrect, per the above .

QUESTION 375
The risk of incorrect acceptance and the likelihood of assessing control risk too low relate to the:

A. Allowable risk of tolerable misstatement.
B. Preliminary estimates of materiality levels.
C. Efficiency of the audit.
D. Effectiveness of the audit.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Both 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.
Choice "a" is incorrect. Allowable risk of tolerable misstatement does not exist.
Choice "b" is incorrect. The risk of incorrect acceptance and risk of assessing control risk too low are unrelated to preliminary estimates of materiality. Choice "c" is incorrect. The efficiency of the audit is related to the risk of incorrect rejection and the risk of assessing control risk too high.

QUESTION 376
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. To determine the number of items to be selected for a particular sample for a test of controls, the auditor should consider the tolerable rate of deviation from the controls being tested, the likely rate of deviations (expected deviation rate), and the allowable risk of assessing control risk too low. Choices "b", "c", and "d" are incorrect, per the above .

QUESTION 377
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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. An increase in tolerable misstatement results in a smaller sample size. An increase in the assessed level of control risk leads to an increase in sample size. Choices "a", "b", and "d" are incorrect, per the above .

QUESTION 378
An advantage of statistical sampling over nonstatistical sampling is that statistical sampling helps an auditor to:

A. Eliminate the risk of nonsampling errors.
B. Reduce the level of audit risk and materiality to a relatively low amount.
C. Measure the sufficiency of the audit evidence obtained.
D. Minimize the failure to detect errors and fraud.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Statistical sampling helps the auditor to measure the sufficiency of the audit evidence because the auditor can quantify the audit risk, thus assisting in limiting it to an acceptable level. Choice "a" is incorrect. Nonsampling errors relate to the improper evaluation of evidence by the auditor and are not dependent on the sampling method used.
Choice "b" is incorrect. Audit risk can be reduced to a relatively low level with non-statistical sampling.
Materiality is not affected by the sampling method used.
Choice "d" is incorrect. The use of statistical sampling does not necessarily minimize the failure to detect errors and fraud.

QUESTION 379
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.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The auditor should consider the tolerable rate of deviation from the control structure policies or procedures being tested, the likely rate of deviations, and the allowable risk of assessing control risk too low. Choice "b" is incorrect. The risk of incorrect acceptance is relevant for substantive tests of details rather than tests of controls.
Choice "c" is incorrect. The nature and cause of the deviation is not considered in determining a sample size for tests of controls. Choice "d" is incorrect. The population size is generally not considered in determining a sample size for tests of controls.

QUESTION 380
An advantage of using statistical over nonstatistical sampling methods in tests of controls is that the statistical methods:

A. Can more easily convert the sample into a dual-purpose test useful for substantive testing.

B. Eliminate the need to use judgment in determining appropriate sample sizes.
C. Afford greater assurance than a nonstatistical sample of equal size.
D. Provide an objective basis for quantitatively evaluating sample risk.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. By using statistical sampling, the auditor can quantify sampling risk to assist in limiting it to a level considered acceptable.
Choice "a" is incorrect. Statistical sampling does not provide any advantage with respect to converting the test into a dual-purpose test.
Choice "b" is incorrect. Statistical sampling still requires judgment to determine sample sizes. The tolerable rate of deviation, the likely rate of deviation, and the allowable risk of assessing control risk too low are all determined by the auditor's professional judgment.
Choice "c" is incorrect. Statistical sampling does not afford greater assurance than a nonstatistical sample of the same size. It only provides the auditor with a better measure of the sufficiency of the evidence found, and helps to evaluate the results found.

QUESTION 381
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.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Ratio estimation is most effective if there is a correlation between book values and audit amounts.
Choice "b" is incorrect. A relatively small number of differences do not improve the effectiveness of ratio estimation sampling relative to other techniques.
Choice "c" is incorrect. Whether populations are stated in terms of quantities or book values is irrelevant in determining the effectiveness of ratio estimation.
Choice "d" is incorrect. Large overstatement and understatement errors do not give the ratio estimation sampling technique an advantage in effectiveness

relative to other sampling techniques.

QUESTION 382
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 control activities 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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Deviations from control activities do not necessarily result in misstatements.
Therefore, deviations from pertinent control activities at a given rate would ordinarily be expected to result in misstatements at a lower rate.
Choice "a" is incorrect. In tests of controls, population size has virtually no effect on sample size unless the population is small.
Choice "c" is incorrect. There is a direct relationship between expected deviation rate and sample size.
Choice "d" is incorrect. Detection risk and sample size are not factors in determining the tolerable deviation rate in a test of controls. The tolerable rate is simply the maximum rate that the auditor is willing to accept without altering his or her planned level of reliance.

QUESTION 383
The likelihood of assessing control risk too high is the risk that the sample selected to test controls:

A. Does not support the auditor's planned assessed level of control risk when the true operating effectiveness of internal control justifies such an assessment.
B. Contains misstatements that could be material to the financial statements when aggregated with misstatements in other account balances or transactions classes.
C. Contains proportionately fewer monetary errors or deviations from prescribed internal controls than exist in the balance or class as a whole.
D. Does not support the tolerable error for some or all of management's assertions.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:

Section: Volume E

Choice "a" is correct. The risk of assessing control risk too high is the risk that the assessed level of control risk based on the sample is greater than the true risk based on the actual operating effectiveness of the control.
Choice "b" is incorrect. Tests of controls are not designed to directly detect misstatements. Tests of controls directed toward the operating effectiveness of an internal control are concerned with how the control was applied, the consistency with which it was applied during the audit period, and by whom it was applied.
Choice "c" is incorrect. The risk that the sample contains proportionately fewer monetary errors or deviations than exist in the class as a whole is the risk of assessing control risk too low. Choice "d" is incorrect. Tolerable misstatements (errors) are related to the results of substantive tests of details, not tests of controls.

QUESTION 384
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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Variables sampling is normally used to estimate a numerical measurement of a population.
Choice "a" is incorrect. Attribute sampling is used when testing controls as part of the auditor's evaluation of a company's internal control.
Choice "b" is incorrect. Stop-or-go sampling is a type of attribute sampling used when testing controls. Choice "d" is incorrect. Random number sampling is a technique used to select a sample.

QUESTION 385
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?

A. Set the tolerable rate of deviation at a lower level than originally planned.
B. Stratify the cash disbursements population so that the unusually large disbursements are selected.
C. Increase the sample size to reduce the effect of the unusually large disbursements.

D. Continue to draw new samples until all the unusually large disbursements appear in the sample.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Stratification involves the grouping of transactions sharing some characteristic (such as recorded amounts). The goal of stratification is to ensure selection of items for which potential misstatements may individually equal or exceed tolerable misstatement. Thus, the auditor should stratify the sample such that the unusually large transactions are selected. Choice "a" is incorrect. The tolerable rate of deviation refers to test of controls, rather than substantive tests.
Choice "c" is incorrect. Certain items should be individually examined; for example, the auditor should examine those items for which potential misstatements may individually equal or exceed tolerable misstatement. Stratifying the sample is more efficient than increasing the sample size.
Choice "d" is incorrect. By stratifying the sample, the auditor can examine each of the unusual transactions and also reduce the sample size.

QUESTION 386
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.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Attribute sampling examines the rate of occurrence in a sample: the attribute either exists or does not exist. Therefore, attribute sampling is more useful for tests of controls, such as the examination of time cards for proper approval.
Choice "a" is incorrect. Attribute sampling is not appropriate for this substantive test of details. Classical variables sampling or Probability-Proportionate-to-Size (PPS) sampling, also known as dollar-unit sampling, is more appropriate.
Choice "b" is incorrect. Attribute sampling is not appropriate for this substantive test of details. Classical variables sampling or Probability-Proportionate-to-Size (PPS) sampling, also known as dollar-unit sampling, is more appropriate. Choice "c" is incorrect. Attribute sampling is not appropriate for this substantive test of

details. Classical variables sampling or Probability-Proportionate-to-Size (PPS) sampling, also known as dollar-unit sampling, is more appropriate.

QUESTION 387

The sample size of a test of controls varies inversely with:

	Expected population deviation rate	Tolerable rate
A.	Yes	Yes
B.	No	No
C.	Yes	No
D.	No	Yes

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The sample size for a test of controls varies directly with the expected deviation rate and inversely with the tolerable rate. If the auditor expects more errors, he or she would increase sample size; conversely, if the tolerable rate of deviation increases, not as many items need to be selected. Choices "a", "b", and "c" are incorrect, per the above .

QUESTION 388

As a result of sampling procedures applied as tests of controls, an auditor incorrectly assesses control risk lower than appropriate. The most likely for this situation is that:

A. The deviation rates of both the auditor's sample and the population exceed the tolerable rate.
B. The deviation rates of both the auditor's sample and the population is less than the tolerable rate.
C. The deviation rate in the auditor's sample is less than the tolerable rate, but the deviation rate in the population exceeds the tolerable rate.

D. The deviation rate in the auditor's sample exceeds the tolerable rate, but the deviation rate in the population is less than the tolerable rate.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. The situation given is an example of sampling risk, or the probability that the sample chosen is not representative of the population as a whole. This is illustrated by the fact that the sample deviation rate is less than the tolerable rate, but the true deviation rate exceeds the tolerable rate.
Choice "a" is incorrect. If both the deviation rates of the sample and the population exceed the tolerable rate, the auditor would assess control risk at the appropriate level.
Choice "b" is incorrect. If both the deviation rates of the sample and the population are less than the tolerable rate, the auditor would assess control risk at the appropriate level.
Choice "d" is incorrect. If the sample deviation rate exceeds the tolerable rate, but the deviation rate in the population does not, this would also result in sampling risk. In this case, however, the auditor would assess control risk at a level higher than appropriate.

QUESTION 389
In performing tests of controls over authorization of cash disbursements, which of the following statistical sampling methods would be most appropriate?

A. Variables.
B. Stratified.
C. Ratio.
D. Attributes.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Attributes sampling is the statistical sampling method used when testing controls.
Choice "a" is incorrect. Variables sampling is used in substantive testing, not in tests of controls.
Choice "b" is incorrect. Stratified sampling is used in conjunction with variables sampling, and is therefore used in substantive testing, not in tests of controls.
Choice "c" is incorrect. Ratio estimation is used in conjunction with variables sampling, and is therefore used in substantive testing, not in tests of controls.

QUESTION 390
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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Inclusion of zero and negative balances requires special design considerations with PPS sampling, but it does not require special design considerations with classical variables sampling.
Choice "a" is incorrect. An estimate of the standard deviation of the population's recorded amounts is required for classical variables sampling, but not for PPS sampling.
Choice "b" is incorrect. The auditor is less likely to need a computer program to design an efficient sample for PPS sampling than for classical variables sampling.
Choice "d" is incorrect. Any amount that is individually significant is more likely to be identified and selected when using PPS sampling than when using classical variables sampling.

QUESTION 391
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 upper deviation rate to be 8%.
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 upper deviation rate (8%).
B. Expected deviation rate (7%) was more than the percentage of errors in the sample (3.5%).
C. Upper deviation rate (8%) was more than the percentage of errors in the sample (3.5%).
D. Expected deviation rate (2.5%) was less than the tolerable rate (7%).

Correct Answer: A
Section: Volume E

Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The auditor decided to increase the level of the preliminary assessment of control risk because the 7% tolerable rate (maximum rate of deviations that an auditor would be willing to accept without altering his/her planned reliance on the control) was less than the 8% upper deviation rate.
Choice "b" is incorrect. The expected deviation rate was 2.5%, not 7%.
Choice "c" is incorrect. The upper deviation rate is always more than the percentage of errors in the sample since the sum of the percentage of the errors and the allowance for sampling risk equals the upper deviation rate. Choice "d" is incorrect. The expected deviation rate is not used in evaluating the sample. It is the upper deviation rate that is compared to the tolerable rate in evaluating a sample.

QUESTION 392
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 2.5% 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 upper deviation rate to be 8%. The allowance for sampling risk was:

A. 5.5%
B. 4.5%
C. 3.5%
D. 1%

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The allowance for sampling risk is the excess of the 8% upper deviation rate over the 3.5% (= 7 Ã· 200) sample deviation rate, or 4.5%.
Choices "a", "c", and "d" are incorrect, based on the above .

QUESTION 393
What is an auditor's evaluation of a statistical sample for attributes when a test of 50 documents results in 3 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.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The auditor's evaluation would be to modify the planned assessed level of control risk because the sample deviation rate of 6% (3/50) plus the allowance for sampling risk of 2% (the sum of which is called the upper deviation rate) exceeded the tolerable rate of 7%.
Choice "a" is incorrect. This option does not consider the actual results of the sample. The sample deviation rate plus the allowance for sampling risk is compared to the tolerable rate. Choice "b" is incorrect. The sample results cannot be accepted because the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate. Choice "c" is incorrect. The tolerable rate (7%) less the allowance (2%) should be compared to the actual deviation rate (6%).

QUESTION 394
An auditor is selecting vouchers for testing an entity's internal control activities related to the proper approval of vouchers before checks are prepared. The auditor is matching random numbers with voucher numbers to determine which vouchers to inspect. If a random number matches a voided voucher, that voucher ordinarily would be replaced by another voucher in the random sample if the voided voucher:

A. Cannot be located in the voucher file.
B. Represents a dollar amount that is material.
C. Indicates a deviation from the prescribed activity.
D. Has been properly voided.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. If a random number matches a properly voided voucher, the auditor would ordinarily replace this with another voucher in order to attain the desired sample size.
Choice "a" is incorrect. A voucher that cannot be located is normally considered a deviation.
Choice "b" is incorrect. The auditor would be particularly concerned with a voided voucher that represents a material amount, but this fact alone would not cause selection of another voucher. Determination of whether to select another voucher or to instead consider this a deviation would depend on whether the voucher was properly voided. Choice "c" is incorrect. If the voided voucher indicates a control deviation, then it would be counted as such.

QUESTION 395
An auditor examining inventory most likely would use variables sampling rather than attributes sampling to:

A. Identify whether inventory items are properly priced.
B. Estimate whether the dollar amount of inventory is reasonable.
C. Discover whether misstatements exist in inventory records.
D. Determine whether discounts for inventory are properly recorded.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Variables sampling is used to determine whether a given account balance is reasonable.
Choice "a" is incorrect. Attribute sampling is used to test the attributes, or characteristics, of each item in a sample. In this case, attribute sampling would be used to determine if proper procedures with respect to pricing were followed for each item in the sample.
Choice "c" is incorrect. Attribute sampling is used to test the attributes, or characteristics, of each item in a sample. In this case, attribute sampling would be used to determine if inventory was properly recorded for each item in the sample. Choice "d" is incorrect. Attribute sampling is used to test the attributes, or characteristics, of each item in a sample. In this case, attribute sampling would be used to determine if discounts were properly applied to inventory for each item in the sample.

QUESTION 396
As a result of tests of controls, an auditor assesses control risk too high. This incorrect assessment most likely occurred because:

A. Control risk based on the auditor's sample is less than the true operating effectiveness of the client's control activity.
B. The auditor believes that the control activity relates to the client's assertions when, in fact, it does not.
C. The auditor believes that the control activity will reduce the extent of substantive testing when, in fact, it will not.
D. Control risk based on the auditor's sample is greater than the true operating effectiveness of the client's control activity.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The risk of assessing control risk too high is the risk that the assessed level of control risk based on the sample is greater than the true risk based on the actual operating effectiveness of the control.
Choice "a" is incorrect. The risk of assessing control risk too low is the risk that the assessed level of control risk based on the sample is less than the true risk based on the actual operating effectiveness of the control.
Choice "b" is incorrect. Assessing control risk too high relates to an incorrect evaluation of risk by the auditor, not to whether the control activity relates to the client's assertions.
Choice "c" is incorrect. If the auditor believes that a control activity will reduce the extent of substantive testing when, in fact, it will not, this implies that the control risk based on the auditor's sample was less than the true risk based on the actual operating effectiveness of the control. This would be an example of assessing control risk too low, not too high.

QUESTION 397
Which of the following characteristics most likely would be an advantage of using classical variables sampling rather than probability-proportional-to-size (PPS) sampling?

A. The selection of negative balances requires no special design considerations.
B. The sampling process can begin before the complete population is available.
C. The auditor need not consider the preliminary judgments about materiality.
D. The sample will result in a smaller sample size if few errors are expected.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Inclusion of negative balances requires special design considerations with PPS sampling, but it does not require special design considerations with classical variables sampling.
Choice "b" is incorrect. All items in the population should have an equal chance to be included in the sample. Therefore, the sampling process should not begin before the complete population is available, regardless of whether classical variables sampling or PPS sampling is used.

Choice "c" is incorrect. When planning a particular sample for a substantive test of details, the auditor should consider preliminary estimates of materiality. Choice "d" is incorrect. If no errors are expected, PPS sampling generally requires a smaller sample than other methods.

QUESTION 398
For which of the following audit tests would a CPA most likely use attribute sampling?

A. Identifying entries posted to incorrect accounts.
B. Estimating the amount in an expense account.
C. Evaluating the reasonableness of depreciation expense.
D. Selecting receivables for confirmation of account balances.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Attribute sampling is used to estimate a rate of occurrence, and often involves a yes-no question. Attribute sampling could be used to determine the error rate in posting journal entries, perhaps by asking, "Is the entry posted to the proper account?"
Choice "b" is incorrect. Variables sampling is typically used to estimate a numerical quantity, such as the amount in an expense account.
Choice "c" is incorrect. Variables sampling is typically used to estimate a numerical quantity, such as a reasonable amount for depreciation expense. Choice "d" is incorrect. Attribute sampling is used to estimate a rate of occurrence, not to select the items to include in a sample.

QUESTION 399
Which of the following statements is correct about the sample size in statistical sampling when testing internal controls?

A. The auditor should consider the tolerable rate of deviation from the controls being tested in determining sample size.
B. As the likely rate of deviation decreases, the auditor should increase the planned sample size.
C. The allowable risk of assessing control risk too low has no effect on the planned sample size.
D. Of all the factors to be considered, the population size has the greatest effect on the sample size.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. There is an inverse relationship between the tolerable deviation rate and sample size: as the auditor is willing to accept a greater deviation rate, a smaller sample size can be used.
Choice "b" is incorrect. There is a direct relationship between expected deviation rate and sample size: as the likely rate of deviation decreases, a smaller sample size can be used.
Choice "c" is incorrect. There is an inverse relationship between the risk of assessing control risk too low and sample size: as the allowable level of risk increases, the sample size decreases. Choice "d" is incorrect. Population size has a relatively small effect on sample size, especially in large populations. The Effect of Information Technology on the Audit

QUESTION 400
Which of the following is the primary reason that many auditors hesitate to use embedded audit modules?

A. Embedded audit modules cannot be protected from computer viruses.
B. Auditors are required to monitor embedded audit modules continuously to obtain valid results.
C. Embedded audit modules can easily be modified through management tampering.
D. Auditors are required to be involved in the system design of the application to be monitored.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Embedded audit modules are sections of the application program code that collect transaction data for the auditor. Embedded audit modules are usually built into the application program when the program is developed. This would require that the auditors be involved in the system design of the application to be monitored.
Choice "a" is incorrect. Embedded audit modules can be protected from computer viruses the same way any other application program would be protected.
Choice "b" is incorrect. Auditors are not required to monitor embedded audit modules continuously to obtain valid results.
Choice "c" is incorrect. As long as there are appropriate controls in place, embedded audit modules cannot easily be modified through management tampering.

QUESTION 401
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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Embedded audit modules are sections of an application program code that collect transaction data for the auditor. Such modules allow the auditor to capture specific data as transactions are being processed. Choices "a", "c", and "d" are incorrect, based on the above .

QUESTION 402
Which of the following is an engagement attribute for an audit of an entity that processes most of its financial data in electronic form without any paper documentation?

A. Discrete phases of planning, interim, and year-end fieldwork.
B. Increased effort to search for evidence of management fraud.
C. Performance of audit tests on a continuous basis.
D. Increased emphasis on the completeness assertion.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Continuous performance of audit tests is required when financial data is processed electronically, without provision of paper documentation, to ensure that controls are operating effectively throughout the period under audit.
Choice "a" is incorrect. Discrete phases of planning, interim, and year-end fieldwork are not effective when there is no audit trail, because no evidence is then available to support the operation of the controls or the accuracy of the financial records for periods when the auditor was not present to conduct tests.
Choice "b" is incorrect. Consideration of the risk of management fraud is required in all audits, regardless of the method used to process financial data or the adequacy of the paper documentation provided. Choice "d" is incorrect. The completeness assertion must be tested in all audit engagements, regardless of the method used to process financial data or the adequacy of the paper documentation provided.

QUESTION 403
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.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. In a paperless system, the CPA would most likely need to continuously monitor and analyze transaction processing to ensure that controls were operating effectively throughout the period under audit. An embedded audit module is one way to achieve this goal.
Choice "b" is incorrect. While segregation of duties is an important control, there would be no reason to increase reliance on such controls in a paperless system.
Choice "c" is incorrect. Verification of encrypted digital certificates used to monitor the authorization of transactions would be used in all computerized systems.
Choice "d" is incorrect. Testing of firewall boundaries that restrict the recording of outside network traffic by itself does not ensure the completeness and accuracy of the financial data.

QUESTION 404
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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Test data consists of "dummy" data run through the client's computer system. The data should be processed under the auditor's control.
Choice "a" is incorrect. Only transactions that the auditor wishes to test must be used.
Choice "c" is incorrect. While the auditor will frequently use many valid and invalid conditions, it is not feasible to test every possible valid and invalid condition using a test data approach. Choice "d" is incorrect. The objective of the test data approach is to test programs that the client uses to process data. Using different programs defeats the primary purpose of the test.

QUESTION 405
Which of the following statements most likely represents a disadvantage for an entity that keeps microcomputer-prepared data files rather than manually prepared files?

A. Attention is focused on the accuracy of the programming process rather than errors in individual transactions.
B. It is usually easier for unauthorized persons to access and alter the files.
C. Random error associated with processing similar transactions in different ways is usually greater.
D. It is usually more difficult to compare recorded accountability with physical count of assets.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. It is easier to access and alter microcomputer data files than manually prepared data files. Microcomputer access security is difficult to maintain because of the increased number of data entry points and the potential ability to defeat access controls.
Choice "a" is incorrect. Once the programs are written, the focus will still be on the accuracy of the transactions.
Choice "c" is incorrect. One of the benefits of an automated system over a manual system is the removal of random errors from the process. (Instead, systematic errors are more common.) Choice "d" is incorrect. There is no significant difference between comparing physical counts with accounting records kept either manually or on an automated system.

QUESTION 406
An auditor most likely would introduce test data into a computerized payroll system to test internal 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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Test data allows the auditor to determine whether adequate controls exist over data processing. Test data consists of fictitious entries or inputs that are processed through the client's computer system under the control of the auditor. The client's computerized payroll system should have adequate controls to prevent input of invalid employee I.D. numbers.
Choice "a" is incorrect. This control does not involve the client's computer system and therefore cannot be tested using test data.
Choice "b" is incorrect. This control does not involve the client's computer system and therefore cannot be tested using test data. Choice "d" is incorrect. This control does not involve the client's computer system and therefore cannot be tested using test data.

QUESTION 407
Using microcomputers in auditing may affect the methods used to review the work of staff assistants because:

A. The audit fieldwork standards for supervision 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 microcomputers.
D. Audit documentation may not contain readily observable details of calculations.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. When using microcomputers in an auditing task, audit documentation may not contain readily observable details of calculations (e.g., present value calculations). In order to review assistants' work, a supervisor may have to examine the formulas used on the microcomputer rather than simply examining the audit documentation.
Choice "a" is incorrect. The standards of fieldwork, specifically planning and supervision, would not change with the use of microcomputers on the audit. Choice "b" is incorrect. Consulting service personnel should not be necessary to document the supervisory review.
Choice "c" is incorrect. The familiarity of supervisory personnel with the capabilities and limitations of microcomputers would not have an effect on the review process.

QUESTION 408

Which of the following statements is not true of the test data approach to testing an accounting system?

A. Test data are processed by the client's computer programs under the auditor's control.
B. The test data need consist of only those valid and invalid conditions that interest the auditor.
C. Only one transaction of each type need be tested.
D. The test data must consist of all possible valid and invalid conditions.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. While the auditor will frequently use many valid and invalid conditions, it is not feasible to test every possible valid and invalid condition using a test data approach. Choice "a" is incorrect. Test data consists of a set of fictitious entries or inputs that are processed through the client's computer system under the control of the auditor.
Choice "b" is incorrect. The auditor need only include valid and invalid conditions that interest the auditor.
Choice "c" is incorrect. Only one transaction of each type need be tested, as the system should process similar transactions in a consistent manner.

QUESTION 409
An auditor would least likely use computer software to:

A. Construct parallel simulations.
B. Access client data files.
C. Prepare spreadsheets.
D. Assess EDP control risk.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The assessment of control risk is based on auditor judgment. A computer cannot replace professional auditor judgment in assessing control risk. Choice "a" is incorrect. Computer software would be used when constructing parallel simulations.

Parallel simulation involves taking the client's data and reprocessing it using the auditor's equipment and software.
Choice "b" is incorrect. The auditor would use generalized audit software or retrieval package software to access client data files. Choice "c" is incorrect. The auditor would most likely use some sort of software to prepare spreadsheets.

QUESTION 410
In parallel simulation, actual client data are reprocessed using an auditor software program. An advantage of using parallel simulation, instead of performing tests of controls without a computer, is that:

A. The test includes all types of transaction errors and exceptions that may be encountered.
B. The client's computer personnel do not know when the data are being tested.
C. There is no risk of creating potentially material errors in the client's data.
D. The size of the sample can be greatly expanded at relatively little additional cost.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Use of computer assisted audit techniques typically allows a greater number of items to be tested at relatively little additional cost. For example, once the auditor has created the software program, it takes little effort to reprocess additional transactions. Manual tests, on the other hand, must be applied separately to each individual transaction, making it more costly to increase sample size.
Choice "a" is incorrect. Reprocessing of actual client data may not include all types of transaction errors and exceptions. Only errors or exceptions in the actual data would be included.
Choice "b" is incorrect. The client's computer personnel likely would be providing the actual client data, and so would have some knowledge of when the data was being tested.
Choice "c" is incorrect. Neither manual testing nor parallel processing includes a risk of corrupting the client's data, since neither one of them affects the client's live data or files.

QUESTION 411
A client that recently installed a new accounts payable system assigned employees a user identification code (UIC) and a separate password. Each UIC is a person's name, and the individual's password is the same as the UIC. Users are not required to change their passwords at initial log-in nor do passwords ever expire. Which of the following statements does not reflect a limitation of the client's computer access control?

A. Employees can easily guess fellow employees' passwords.
B. Employees are not required to change passwords.
C. Employees can circumvent procedures to segregate duties.

D. Employees are not required to take regular vacations.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The requirement that employees take regular vacations is a good internal control, but it is unrelated to computer-access controls.
Choice "a" is incorrect. Using employee's names as their passwords is an ineffective computer-access control, because passwords are easily guessed.
Choice "b" is incorrect. It would be acceptable to assign employee names as passwords, as long as the employees were required to change their passwords at initial log-in as well as periodically in the future.
The fact that this requirement is not in place is a limitation of the client's computer-access controls.
Choice "c" is incorrect. If password controls are used to segregate the duties of individual employees, using employee names as passwords allows an employee to circumvent this segregation by logging in with another employee's password.

QUESTION 412
When conducting field work for a physical inventory, an auditor cannot perform which of the following steps using a generalized audit software package?

A. Observing inventory.
B. Selecting sample items of inventory.
C. Analyzing data resulting from inventory.
D. Recalculating balances in inventory reports.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. A generalized audit software package (GASP) is used to perform tests directly on a client's system. Since observing inventory involves personal observations made by the auditor, and is unrelated to the client's system, a GASP would not be useful in this regard.
Choice "b" is incorrect. Generalized audit software packages (GASPs) are used to perform tests directly on a client's system. Tasks typically performed by GASPs include selecting items that meet specified criteria.
Choice "c" is incorrect. Generalized audit software packages (GASPs) are used to perform tests directly on a client's system. Tasks typically performed by GASPs include performing statistical analysis of data. Choice "d" is incorrect. Generalized audit software packages (GASPs) are used to perform tests directly on

a client's system. Tasks typically performed by GASPs include recalculating amounts and totals.

QUESTION 413
When an auditor tests the internal controls of a computerized accounting system, which of the following is true of the test data approach?

A. Test data are coded to a dummy subsidiary so they can be extracted from the system under actual operating conditions.
B. Test data programs need not be tailor-made by the auditor for each client's computer applications.
C. Test data programs usually consist of all possible valid and invalid conditions regarding compliance with internal controls.
D. Test data are processed with the client's computer and the results are compared with the auditor's predetermined results.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The test data approach refers to a technique in which the client's application program is used to process a set of test data, the results of which are already known by the auditor. If the client's program is operating effectively, it should generate the same results determined by the auditor.
Choice "a" is incorrect. An integrated test facility (not a test data approach) utilizes dummy accounts. For example, using an integrated test facility (ITF) approach, test data is initially commingled with live data, but coding to a dummy account allows later extraction from the system under actual operating conditions.
Choice "b" is incorrect. Test data programs should be tailor-made by the auditor for each client's computer applications, to ensure that the data is in an appropriate form for that client's system, and that it includes the types of invalid conditions in which the auditor is interested.
Choice "c" is incorrect. Test data contains the types of valid and invalid conditions in which the auditor is interested (it is not necessary to test all combinations of valid and invalid conditions).

QUESTION 414
When companies use information technology (IT) extensively, evidence may be available only in electronic form. What is an auditor's best course of action in such situations?

A. Assess the control risk as high.
B. Use audit software to perform analytical procedures.
C. Use generalized audit software to extract evidence from client databases.
D. Perform limited tests of controls over electronic data.

Correct Answer: C
Section: Volume E

Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. When companies use information technology (IT) extensively and evidence is available only in electronic form, generalized audit software packages generate the programs necessary to interrogate the files and extract and analyze the data.
Choice "a" is incorrect. The use of information technology does not automatically imply that control risk is high. The auditor would need to evaluate the client's controls to make this determination.
Choice "b" is incorrect. Although audit software might be used to perform analytical procedures, the data would first need to be extracted from the client's system. A generalized audit software package is the best way to do this. Choice "d" is incorrect. If information technology is used extensively, the auditor would likely perform more than limited tests of controls over electronic data.
Internal Control Communications

QUESTION 415
Which of the following factors should an auditor consider in making a judgment about whether a control deficiency is a significant deficiency?
I. The likelihood that a control will fail to prevent or detect a misstatement.
II. The magnitude of the misstatement that could result from the deficiency.

A. I only.
B. II only.
C. Both I and II.
D. Neither I nor II.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. When evaluating whether a control deficiency is a significant deficiency or a material weakness, the auditor should consider both the likelihood and magnitude of any potential misstatement. Choices "a", "b", and "d" are incorrect, based on the above.

QUESTION 416
Which of the following statements is correct concerning significant deficiencies in internal control with respect to an audit of a nonissuer?

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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Because timely communication may be important, the auditor may choose to communicate significant deficiencies during the course of the audit rather than after the audit is concluded. Choice "a" is incorrect. The auditor is not obligated to search for significant deficiencies.
Choice "b" is incorrect. All material weaknesses are significant deficiencies, but not all significant deficiencies are material weaknesses.
Choice "d" is incorrect. Because of the potential for misinterpretation, the auditor should not issue a written report representing that no significant deficiencies were noted during the audit.

QUESTION 417
Significant deficiencies are matters that come to an auditor's attention that should be communicated to an entity's management and those charged with governance because they represent:

A. Disclosures of information that significantly contradict the auditor's going concern assumption.
B. Material fraud or illegal acts perpetrated by high-level management.
C. Deficiencies in the design or operation of internal control that could reasonably be expected to cause a non-inconsequential misstatement in the financial statements.
D. Manipulation or falsification of accounting records or documents from which financial statements are prepared.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Significant deficiencies in the design or operation of internal control should be communicated to management and those charged with governance because there is more than a remote likelihood that they will result in a financial statement misstatement that is more than inconsequential.
Choice "a" is incorrect. Information that significantly contradicts the auditor's going concern assumption is not considered a significant deficiency.

Choice "b" is incorrect. Fraud perpetrated by high-level managers should be reported to the audit committee / those charged with governance, but it does not necessarily represent a significant deficiency in internal control.
Choice "d" is incorrect. Fraud should be reported to an appropriate level of management, and sometimes to the audit committee / those charged with governance, but it does not necessarily represent a significant deficiency in internal control.

QUESTION 418
Which of the following matters would an auditor most likely consider to be a significant deficiency in internal control to be communicated to management and those charged with governance?

A. Management's failure to renegotiate unfavorable long-term purchase commitments.
B. Recurring operating losses that may indicate going concern problems.
C. Evidence of a lack of objectivity by those responsible for accounting decisions.
D. Management's current plans to reduce its ownership equity in the entity.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. A lack of objectivity by those responsible for accounting decisions represents a significant internal control deficiency because it may result in financial statements that are biased rather than being presented fairly. Choice "a" is incorrect. Management's failure to renegotiate unfavorable long-term purchase commitments does not represent a significant deficiency in internal control.
Choice "b" is incorrect. Going concern problems do not represent a significant deficiency in internal control.
Choice "d" is incorrect. Management's plan to reduce its ownership equity in the entity does not represent a significant deficiency in internal control.

QUESTION 419
A report on a nonissuer's internal control should include a statement limiting the use of the report when:

A. Management's assertion is presented in a separate report that will accompany the CPA's report.
B. Management's assertion is presented as a representation letter to the CPA.
C. Management's assertion is presented based upon criteria that are available to specific parties.
D. Management's assertion is not presented.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. When management's assertion is presented based on criteria that are only appropriate for or available to specific parties, the report should contain a statement limiting its use. Examples include reports based on criteria specified by a regulatory agency and reports based on criteria agreed to by management and some other specified party.
Choice "a" is incorrect. There is no requirement to limit the use of the report when management's assertion accompanies the CPA's report.
Choice "b" is incorrect. When management's assertion is presented as a representation letter to the CPA, the report should include a statement of management's assertion, but there is no requirement to limit the use of the report. Choice "d" is incorrect. Management is required to present its written assertion about the effectiveness of the entity's internal control as a condition of engagement performance.

QUESTION 420
When management's assertion about the effectiveness of a nonissuer's internal control is presented in a representation letter that will not accompany the CPA's report:

A. Use of the report is restricted to management and the board of directors.
B. The report should contain a statement of management's assertion.
C. The CPA should not accept the engagement.
D. The report should include a negative assurance with respect to the effectiveness of the entity's internal control.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. When management's assertion does not accompany the CPA's report, the first paragraph of the report should contain a statement of management's assertion. Choice "a" is incorrect. There is no requirement to limit the use of the report, but the report must include a statement of management's assertion.
Choice "c" is incorrect. The CPA may accept such an engagement but is required to include management's assertion in the report.
Choice "d" is incorrect. Negative assurance is prohibited with respect to a report on the effectiveness of an entity's internal control.

QUESTION 421
Which of the following conditions is necessary for a practitioner to accept an attest engagement to examine and report on a nonissuer's internal control over financial reporting?

A. The practitioner anticipates relying on the entity's internal control in a financial statement audit.
B. Management presents its written assertion about the effectiveness of internal control.
C. The practitioner is a continuing auditor who previously has audited the entity's financial statements.
D. Management agrees not to present the practitioner's report in a general-use document to stockholders.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. In order for a practitioner to examine and report on management's assertion about the effectiveness of an entity's internal control, management must present its written assertion about the effectiveness of internal control.
Choice "a" is incorrect. The examination may be made separately from or in conjunction with an audit, and there is no requirement that the practitioner rely on internal control. Choice "c" is incorrect. No requirement for previous engagement experience exists in order to report on a client's internal control. Choice "d" is incorrect. The practitioner's report is considered appropriate for general distribution.

QUESTION 422
Which of the following statements is correct concerning an auditor's required communication of significant deficiencies in internal control noted during an audit of a nonissuer?

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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. The report should state that the communication is intended solely for the use of management, those charged with governance, and others within the organization.
Choice "a" is incorrect. Significant deficiencies may represent a conscious decision by management to accept that degree of risk because of cost or other

considerations. The auditor may elect to use a primarily substantive approach to test balances, so internal control deficiencies do not necessarily constitute a scope limitation.
Choice "b" is incorrect. No requirement to perform tests of controls exists. Significant deficiencies may be identified through the consideration of internal control, the application of audit procedures to balances or transactions, or otherwise during the course of the audit.
Choice "d" is incorrect. Significant deficiencies may be communicated during or after the audit.

QUESTION 423
Snow, CPA, was engaged by Master Co., a nonissuer, to examine and report on management's written assertion about the effectiveness of Master's internal control over financial reporting. Snow's report should state that:

A. Because of inherent limitations of any internal control, errors or fraud may occur and not be detected.
B. Management's assertion is based on criteria established by the American Institute of Certified Public Accountants.
C. The results of Snow's tests will form the basis for Snow's opinion on the fairness of Master's financial statements in conformity with GAAP.
D. The purpose of the engagement is to enable Snow to plan an audit and determine the nature, timing, and extent of tests to be performed.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The practitioner's report should include a paragraph stating that because of the inherent limitations of any internal control, errors and fraud may occur and not be detected.
Choice "b" is incorrect. The examination is performed in accordance with standards established by the AICPA, but management's assertion may be based on criteria established by some other recognized body.
Choice "c" is incorrect. An examination (an attestation engagement) of management's assertion on the effectiveness of an entity's internal control over financial reporting does not provide a sufficient basis for an opinion on the fairness of the financial statements.
Choice "d" is incorrect. An examination of management's assertion on the effectiveness of an entity's internal control over financial reporting is performed solely to report on that assertion, and not to plan an audit.

QUESTION 424
Which of the following best describes a CPA's engagement to report on a nonissuer's internal control over financial reporting?

A. An attestation engagement to examine and report on management's written assertions about the effectiveness of its internal control.
B. An audit engagement to render an opinion 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.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. An engagement to report on an entity's internal control is best described as an attestation engagement to examine and report on management's written assertions about the effectiveness of its internal control.
Choice "b" is incorrect. An audit involves expressing (or disclaiming) an opinion on historical financial statements. An engagement to report on internal control is an attestation engagement and not an audit.
Thus, the engagement is covered under the attestation standards rather than GAAS.
Choice "c" is incorrect. A prospective engagement is not appropriate for a report on internal control. In fact, the CPA's report includes an "inherent limitations" paragraph stating that projections of the internal control evaluation to the future are risky, since conditions or the degree of compliance may change.
Choice "d" is incorrect. In a consulting engagement, the practitioner develops findings, conclusions, and recommendations, but does not report on an assertion that is the responsibility of another party. When a CPA reports on an entity's internal control, he or she is in effect reporting on management's assertion.

QUESTION 425
When communicating internal control related matters noted in an audit of a nonissuer, an auditor's report issued on significant deficiencies should indicate that:

A. Errors or fraud may occur and not be detected because there are inherent limitations in any internal control.
B. The issuance of an unqualified opinion on the financial statements may be dependent on corrective follow-up action.
C. A material weakness exists when the deficiencies noted were not detected within a timely period by employees in the normal course of performing their assigned functions.
D. The purpose of the audit was to report on the financial statements and not to provide assurance on internal control.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Any report issued on significant deficiencies should indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on internal control.
Choice "a" is incorrect. A statement that errors or irregularities may occur and not be detected due to inherent limitations in internal control is included in the report when an auditor is engaged to express an opinion on internal control, not when the auditor is reporting as part of an audit.

Choice "b" is incorrect. The issuance of an unqualified opinion on the financial statements is never dependent on corrective follow-up action.
Choice "c" is incorrect. A control deficiency (and not necessarily a material weakness) exists when deficiencies are not detected within a timely period by employees in the normal course of performing their assigned functions.

QUESTION 426
A letter issued on significant deficiencies relating to an entity's internal control observed during an audit of the financial statements of a nonissuer should include a:

A. Restriction on the use of the report.
B. Description of tests performed to search for material weaknesses.
C. Statement of compliance with applicable laws and regulations.
D. Paragraph describing management's evaluation of the effectiveness of internal control.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Any report issued on significant deficiencies noted during an audit should (1) indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on internal control, (2) include the definition of significant deficiencies, and (3) include a restriction on the use of the report.
Choice "b" is incorrect. Because the auditor does not search for material weaknesses, a description of tests performed in this regard would not be included in a written report.
Choice "c" is incorrect. There is no required statement of compliance with applicable laws and regulations in a letter issued on significant deficiencies. Choice "d" is incorrect. There is no paragraph describing management's evaluation in a letter issued on significant deficiencies.

QUESTION 427
How do the scope, procedures, and purpose of an engagement to express a separate opinion on a nonissuer's 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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. In an engagement to express a separate opinion on an entity's internal control, the scope is extensive, and the purpose is directed primarily toward the internal control report. In an audit, the scope is less extensive, and the purpose is to determine the nature, timing, and extent of auditing procedures. Similar procedures generally would be used in both types of engagements. Choices "a", "b", and "c" are incorrect, based on the above .

QUESTION 428
Rachel, CPA, is conducting an audit of Eaton Enterprises, a nonissuer. Rachel has conducted her audit in accordance with generally accepted auditing standards, and she wishes to emphasize in her report that such standards do not require the same level of testing and reporting on internal control as is required for audits of issuers under the Sarbanes-Oxley Act. Which report modification would be most appropriate in this situation?

A. Only the scope paragraph should be modified.
B. An explanatory paragraph should be added following the opinion paragraph.
C. An explanatory paragraph should be added preceding the opinion paragraph, and the opinion paragraph should state, "Except for the matter discussed in the preceding paragraph..."
D. No report modification should be made in this scenario.

Correct Answer: A

Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The auditor may expand the scope paragraph to state that internal control was considered as a basis for designing appropriate audit procedures, but not for the purpose of expressing an opinion on the effectiveness of internal control. This serves to emphasize that the extended level of testing and reporting on internal control required by the Sarbanes-Oxley Act did not apply in this case.
Choice "b" is incorrect. The auditor should modify the scope paragraph, not add an additional explanatory paragraph.
Choice "c" is incorrect. An "except for" qualified opinion would not be appropriate in this case.
Choice "d" is incorrect. Although a report modification is not required, the question-states that Rachel wishes to emphasize the scope of her work on internal control. In such situations, the scope paragraph should be modified.

QUESTION 429
Hannah, CPA, has been engaged to perform financial statement audits for three different clients. The first two clients, McCormick Surf Shop and Kleinpeter Technologies, are both nonissuers, while the third client, Bender Industries, is an issuer. Hannah is required to follow PCAOB standards in her audit of Bender Industries. She has also been asked to conduct the Kleinpeter audit in accordance with both generally accepted auditing standards and the auditing standards of the PCAOB. Regarding the McCormick engagement, Hannah has decided to follow only generally accepted auditing standards, and not the standards of the PCAOB. Which of the following best describes the scope of Hannah's work related to internal control in these three engagements?

A. Hannah must express an opinion on the effectiveness of internal control in all three engagements.
B. Hannah must express an opinion on the effectiveness of internal control in both the Bender and Kleinpeter engagements, but is not required to express such an opinion in the McCormick engagement.
C. Hannah must express an opinion on the effectiveness of internal control in the Bender engagement, but is not required to express such an opinion in the Kleinpeter and McCormick engagements.
D. Hannah is not required to express an opinion on the effectiveness of internal control in any of the three engagements, since she was hired to perform a financial statement audit and not to report on internal control.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Be careful! While it is true that Hannah is following PCAOB standards in both the Bender and Kleinpeter engagements, PCAOB standards do not require expanded testing and reporting on internal control for nonissuers.

Therefore, only in the Bender engagement would Hannah be required to express an opinion on the effectiveness of internal control.
Choice "a" is incorrect. Hannah is not required to express an opinion on internal control in either the Kleinpeter engagement (because PCAOB standards do not require such an opinion for financial statement audits of nonissuers) or the McCormick engagement (because generally accepted auditing standards do not require such an opinion for financial statement audits).
Choice "b" is incorrect. Hannah is not required to express an opinion on internal control in the Kleinpeter engagement because PCAOB standards do not require such an opinion for financial statement audits of nonissuers.
Choice "d" is incorrect. Hannah is required to express an opinion on internal control in the Bender engagement. PCAOB standards require the auditor to express such an opinion, in conjunction with financial statement audits of issuers.

QUESTION 430
Which of the following is true regarding significant deficiencies in internal control?

A. Auditors must search for them.
B. Auditors must communicate them to management and to those charged with governance.
C. They must be included in the financial statements.
D. They must be disclosed in footnotes.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The auditor is required to communicate to management and to those charged with governance (the audit committee) any significant deficiencies in internal control that the auditor observes.
Choice "a" is incorrect. The auditor is not obligated to search specifically for significant deficiencies in internal control.
Choice "c" is incorrect. Significant deficiencies in internal control are not typically included in the financial statements, as they relate to controls and not to the presentation and disclosure of financial information.
Choice "d" is incorrect. Significant deficiencies in internal control are not typically included in the footnotes to the financial statements, as they relate to controls and not to the presentation and disclosure of financial information.

QUESTION 431
Management of Eva Industries, an issuer as defined under the Sarbanes-Oxley Act, believes it has eliminated a material weakness previously noted in its assessment of internal control, and has hired Henna and Company, CPAs, to attest to the improvements in internal control. Which of the following is true of this engagement?

A. It is required by PCAOB standards.
B. It is only required if Eva Industries elects to have an audit in accordance with PCAOB standards.

C. Eva's management must provide a written report to accompany Henna and Company's report.
D. It is required by generally accepted auditing standards.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Eva's management must provide a written report to accompany Henna and Company's report.
Choices "a" and "d" are incorrect. An engagement to report on whether a previously reported internal control weakness continues to exist is a voluntary engagement, not required by professional standards.
Choice "b" is incorrect. An engagement to report on whether a previously reported internal control weakness continues to exist is a voluntary engagement, not required by professional standards. In addition, as an issuer, Eva must have an audit in accordance with PCAOB standards.

QUESTION 432
For a nonissuer, a control deficiency would be considered a significant deficiency when the likelihood and magnitude of potential financial statement misstatements are:

	Likelihood	*Magnitude*
A.	More than remote	Material
B.	Probable	Material
C.	More than remote	More than inconsequential
D.	Probable	More than inconsequential

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:

Section: Volume E

Choice "c" is correct. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. Choices "a", "b", and "d" are incorrect, based on the above.

QUESTION 433

For a nonissuer, a control deficiency would be considered a material weakness when the likelihood and magnitude of potential financial statement misstatements are:

	Likelihood	Magnitude
A.	More than remote	Material
B.	Probable	Material
C.	More than remote	More than inconsequential
D.	Probable	More than inconsequential

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the entity's financial statements will not be prevented or detected.
Choices "b", "c", and "d" are incorrect, based on the above.

QUESTION 434

In an audit of an issuer:
I. Management must assess and report on internal control. II. The auditor must assess and report on internal control.

A. I only.
B. II only.
C. Either I or II.
D. Both I and II.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. It is management's responsibility to assess and report on internal control, but the auditor is also required to assess and report on internal control. Choices "a", "b", and "c" are incorrect, based on the above.

QUESTION 435
In an audit of an issuer, the auditor must provide an opinion on which of the following?
I. The financial statements.
II. The audit committee's oversight of financial reporting and internal control.
III. The effectiveness of internal control.

A. I and III only.
B. I, II, and III.
C. I and II only.
D. I only.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The auditor provides an opinion on the entity's financial statements and on the effectiveness of internal control. The auditor is not required to provide an opinion on the audit committee's oversight (but is required to report to the board when such oversight is ineffective).
Choices "b", "c", and "d" are incorrect, based on the above.

QUESTION 436
Which of the following best describes the responsibility of the auditor to report significant deficiencies and material weaknesses in an audit of a nonissuer?

A. The auditor must communicate both significant deficiencies and material weaknesses.
B. The auditor must communicate material weaknesses, but need not disclose significant deficiencies.
C. The auditor must communicate significant deficiencies, but need not separately identify material weaknesses.
D. Neither significant deficiencies nor material weaknesses are required to be communicated.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. In an audit of a nonissuer, the auditor is required to communicate both significant deficiencies and material weaknesses to management and those charged with governance.
Choice "b" is incorrect. The auditor is required to communicate significant deficiencies.
Choice "c" is incorrect. The auditor's report includes the definition of significant deficiencies and a list of such deficiencies noted, followed by the definition of material weaknesses and a list of such weaknesses noted. Choice "d" is incorrect. Both significant deficiencies and material weaknesses are required to be communicated to management and those charged with governance.

QUESTION 437
Which of the following best describes the responsibility of the auditor with respect to significant deficiencies and material weaknesses in an audit of an issuer?

	Must be Communicated to Management and the Audit Committee	*Results in an Adverse Opinion on the Effectiveness of Internal Control*
A.	Both significant deficiencies and material weaknesses	Both significant deficiencies and material weaknesses
B.	Both significant deficiencies and material weaknesses	Material weaknesses but not significant deficiencies
C.	Material weaknesses but not significant deficiencies	Both significant deficiencies and material weaknesses
D.	Material weaknesses but not significant deficiencies	Material weaknesses but not significant deficiencies

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. In an audit of an issuer, the auditor is required to communicate both significant deficiencies and material weaknesses to management and the audit committee, but only material weaknesses result in an adverse opinion on the effectiveness of internal control.
Choice "a" is incorrect. In an audit of an issuer, significant deficiencies (that do not rise to the level of being material weaknesses) do not result in an adverse opinion on the effectiveness of internal control.
Choice "c" is incorrect. In an audit of an issuer, both significant deficiencies and material weaknesses must be communicated, in writing, to management and the audit committee. In addition, significant deficiencies (that do not rise to the level of being material weaknesses) do not result in an adverse opinion on the effectiveness of internal control.
Choice "d" is incorrect. In an audit of an issuer, the auditor is required to communicate both significant deficiencies and material weaknesses to management and the audit committee.

QUESTION 438
Which of the following best describes the responsibility of the auditor to report significant deficiencies and material weaknesses in an attest engagement to examine the effectiveness of a nonissuer's internal control?

A. The auditor must communicate both significant deficiencies and material weaknesses.
B. The auditor must communicate material weaknesses, but need not disclose significant deficiencies.
C. The auditor must communicate significant deficiencies, but need not separately identify material weaknesses.
D. Neither significant deficiencies nor material weaknesses are required to be communicated.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. In an attest engagement to examine the effectiveness of an entity's internal control, the auditor must communicate both significant deficiencies and material weaknesses to management and those charged with governance.
Choice "b" is incorrect. The auditor is required to communicate significant deficiencies.
Choices "c" and "d" are incorrect. Both significant deficiencies and material weaknesses are required to be communicated to management and those charged with governance.

QUESTION 439
Which of the following statements describes an auditor's obligation to identify deficiencies in the design or operation of internal control?

A. The auditor should design and apply tests of controls to discover significant deficiencies in internal control that could result in material misstatements.
B. The auditor need not search for significant deficiencies in internal control unless management requests an attestation that "no significant deficiencies in internal control were noted in the audit."
C. The auditor should search for significant deficiencies in internal control if the auditor expects that controls are operating effectively (i.e., if the auditor plans to rely on controls).
D. The auditor need not search for significant deficiencies in internal control but should document and communicate any such deficiencies that are discovered.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The auditor need not search for significant deficiencies in internal control, but should document and communicate any such deficiencies that are discovered.
Choice "a" is incorrect. Tests of controls are designed and applied to evaluate the risk of financial statement misstatement, and to determine the nature, timing, and extent of substantive tests to be performed. They are not designed to discover significant deficiencies in internal control.
Choice "b" is incorrect. Searching for significant deficiencies in internal control is not part of an audit, and it would be inappropriate for the auditor to state that no significant deficiencies in internal control were noted (even if management requested such a statement).
Choice "c" is incorrect. Searching for significant deficiencies in internal control is not part of an audit even if the auditor expects that controls are operating effectively (i.e., expects to rely on controls).

QUESTION 440
For a nonissuer, a previously communicated significant deficiency that has not been corrected, ordinarily should be communicated again:

A. Only if the deficiency has a material effect on the auditor's assessment of control risk.
B. Unless the entity accepts that degree of risk because of cost-benefit considerations.

C. Only if the deficiency is considered a material weakness.
D. In writing, during the current audit.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. A previously communicated significant deficiency that has not been corrected ordinarily should be communicated again in writing, during the current audit.
Choices "a" and "c" are incorrect. The auditor is required to communicate significant deficiencies each year, regardless of whether the deficiency has a material effect on the auditor's assessment of control risk or the deficiency is considered a material weakness.
Choice "b" is incorrect. The auditor is required to communicate significant deficiencies each year, even if the entity accepts that degree of risk because of cost-benefit considerations.

QUESTION 441
Which of the following best describes an auditor's responsibility with respect to communicating internal control deficiencies of issuers?

A. The auditor is required to communicate all deficiencies in internal control to management, deficiencies that constitute a significant deficiency to the audit committee, and deficiencies that constitute a material weakness to the full board ofdirectors.
B. The auditor is required to communicate all deficiencies in internal control to management, and deficiencies that constitute a significant deficiency or a material weakness to management and the audit committee.
C. The auditor is not required to communicate control deficiencies to management or the audit committee unless they constitute a significant deficiency or a material weakness.
D. The auditor is not required to communicate control deficiencies or significant deficiencies to management or the audit committee, but must communicate material weaknesses to both management and the audit committee.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The auditor is required to communicate all deficiencies in internal control to management, and deficiencies that constitute a significant

deficiency or a material weakness to management and the audit committee. Choice "a" is incorrect. There is no requirement that material weaknesses be communicated to the full board of directors.
Choice "c" is incorrect. The auditor is required to communicate all deficiencies in internal control to management.
Choice "d" is incorrect. The auditor is also required to communicate significant deficiencies to management and the audit committee.

QUESTION 442
In which case might an auditor of an issuer render a qualified opinion on internal control?

A. When there is a scope limitation.
B. When there is a material weakness in internal control.
C. Both "a" and "b".
D. Neither "a" nor "b".

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement, and a material weakness in internal control requires the auditor to issue an adverse opinion. Neither situation would result in a qualified opinion.
Choice "a" is incorrect. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement.
Choice "b" is incorrect. A material weakness in internal control requires the auditor to issue an adverse opinion.
Choice "c" is incorrect. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement, and a material weakness in internal control requires the auditor to issue an adverse opinion. Neither situation would result in a qualified opinion.

QUESTION 443
Gail is auditing the financial statements of Hoefener Home Improvements, a publicly held company. Gail notes several deficiencies in internal control, and is trying to determine whether each deficiency constitutes a significant deficiency or a material weakness. Which best describes the framework Gail should use in making this evaluation?

A. A significant deficiency exists for weaknesses that are important enough to merit the attention of those responsible for financial reporting, and a material weakness exists when there is a reasonable possibility of material misstatement.
B. A significant deficiency exists when there is more than a remote chance of a more than inconsequential misstatement, and a material weakness exists when there is more than a remote chance of a material misstatement.
C. A significant deficiency exists when there is more than a remote chance of a more than inconsequential misstatement, and a material weakness exists when there is a reasonable possibility of material misstatement.

D. A significant deficiency exists for weaknesses that are important enough to merit the attention of those responsible for financial reporting, and a material weakness exists when there is more than a remote chance of a materialmisstatement.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. For issuers, a significant deficiency exists for weaknesses that are important enough to merit the attention of those responsible for financial reporting, and a material weakness exists when there is a reasonable possibility of material misstatement.
Choice "b" is incorrect. For nonissuers, a significant deficiency exists when there is more than a remote chance of a more than inconsequential misstatement, and a material weakness exists when there is more than a remote chance of a material misstatement. However, Hoefener is an issuer, so different rules apply.
Choice "c" is incorrect. For issuers, a significant deficiency exists for weaknesses that are important enough to merit the attention of those responsible for financial reporting. Choice "d" is incorrect. For issuers, a material weakness exists when there is a reasonable possibility of material misstatement.

QUESTION 444
The auditor's report on internal controls and compliance with laws and regulations in accordance with Government Auditing Standards (the Yellow Book), is required to include:
I. The scope of the auditor's testing of internal controls.
II. Uncorrected misstatements that were determined by management to be immaterial.

A. I only.
B. II only.
C. Both I and II.
D. Neither I nor II.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The scope of the auditor's testing of internal controls is required to be included in the auditor's report on internal controls and compliance with laws and regulations in accordance with Government Auditing Standards (the Yellow Book).
Choices "b" and "c" are incorrect. Immaterial uncorrected misstatements are not included in the auditor's report on internal controls and compliance with laws

and regulations.
Choice "d" is incorrect. The scope of the auditor's testing of internal controls is required to be included in the auditor's report on internal controls and compliance with laws and regulations in accordance with Government Auditing Standards (the Yellow Book).

QUESTION 445
In performing an audit in accordance with Generally Accepted Government Auditing Standards (the "Yellow Book"), the auditor:

A. Accepts less responsibility in conducting fieldwork than is accepted in a GAAS audit, since the specific requirements of the Generally Accepted Government Auditing Standards reduce required professional judgment.
B. Accepts shared responsibility with Federal Inspectors General, who are equally responsible for compliance evaluation, control, and reporting.
C. Accepts greater reporting responsibilities than accepted under a GAAS audit, since the auditor must report on compliance with laws, rules, and regulations, violations of which may affect financial statement amounts, and on theorganization's internal control over financial reporting.
D. Accepts equal reporting responsibilities with that accepted under GAAS audits, since compliance evaluation and reporting have implied financial statement implications and require expanded treatment as a material contingency.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. An auditor's reporting requirements under Generally Accepted Government Auditing Standards (GAGAS or the Yellow Book) are expanded to include reports on the audited entity's compliance with laws, rules, and regulations that have a material impact on the financial statements and on internal controls over financial reporting. Rule: Reporting responsibilities under GAGAS are expanded to include:
1. Reports on compliance with laws, rules, and regulations, violations of which may affect financial statement amounts, and
2. Reports on internal control over financial reporting.
Choice "a" is incorrect. Specific reporting requirements and other expanded audit standards associated with Yellow Book audits do not reduce professional judgment.
Choice "b" is incorrect. Federal Inspectors General do not split their responsibilities with independent public accountants performing Yellow Book Audits.
Choice "d" is incorrect. Although Yellow Book requirements represent logical extensions of generally accepted auditing standards, the specific responsibilities undertaken in an audit that requires application of the Yellow Book would not surface as a result of an audit under generally accepted auditing standards.

QUESTION 446
Government Auditing Standards published by the Government Accountability Office:

A. Only apply to audits of governments.
B. Only apply to audits of governments receiving federal financial assistance.

C. Primarily apply to audits of federal financial assistance.
D. Only apply to audits of federal financial assistance programs operated by state and local governments.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Generally Accepted Government Auditing Standards primarily apply to audits of federal financial assistance but have been adopted by some states for audits of state financial assistance.
Choice "a" is incorrect. Government Auditing Standards will apply to federal financial assistance received by governments, not-for-profit organizations, or other organizations. GAGAS may also extend to other financial assistance depending on whether those standards have been adopted by the state providing the assistance.
Choice "b" is incorrect. Government Auditing Standards will apply to federal financial assistance received by governments, not-for-profit organizations, or other organizations, not only to governments. Choice "d" is incorrect. Government Auditing Standards will apply to federal financial assistance received by governments, not-for-profit organizations, or other organizations, not only to governments.

QUESTION 447
Gearty & Duffy, certified public accountants, have been engaged to perform a single audit of Sleepy Knoll Township, a local government receiving substantial federal financial assistance for community development and housing assistance. A single audit represents:

A. An audit of annual activity of only federal financial assistance programs over the course of the town's fiscal year.
B. An inception to date audit of only federal financial assistance programs over the course of the grant year specified by the grant award.
C. An audit of the township's financial statements and of compliance with federal regulations relating to federal financial assistance as prescribed by the Single Audit Act and OMB Circular A-133.
D. An audit of the township's financial statements and the fair presentation of the revenues derived from federal financial assistance.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. A single audit represents a combined audit of both an entity's financial statements and federal financial assistance programs. The single

audit provides audited organizations with the opportunity to capitalize on the efficiency of satisfying their audit requirements with a single audit.
Auditors are governed by the Single Audit Act and OMB Circular A-133.
Choice "a" is incorrect. A single audit is not simply an audit of federal financial assistance. Choice "b" is incorrect. A single audit is not simply an audit of federal financial assistance.
Choice "d" is incorrect. A single audit is not limited to expression of an opinion on the fair presentation of financial statements. It also is designed to report on compliance with laws, rules, and regulations.

QUESTION 448
An audit performed in accordance with OMB Circular A-133 will expand the auditor's responsibilities beyond generally accepted auditing standards. The auditor's expanded responsibilities include:

A. Performance of additional procedures to test and report on compliance with laws, rules, regulations and provisions of contracts or grant agreements that have any effect on federal award programs.
B. Performance of additional procedures to test for noncompliance with laws, rules and regulations targeted for review by the Office of the Inspector General.
C. Performance of additional procedures to test and report on compliance with laws, rules, regulations and provisions of contracts or grant agreements that have a direct and material effect on major federal award programs.
D. Performance of additional procedures to test and report on achievement of program objectives.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. OMB Circular A-133 expands the auditor's responsibilities to include procedures designed to test and report on compliance matters having a direct and material effect on major federal award programs.
Choice "a" is incorrect. OMB Circular A-133 expands procedures to major programs as defined by the Circular, not to all programs.
Choice "b" is incorrect. OMB Circular A-133 audit objectives relate to management's assertions regarding compliance with laws, rules, and regulations, not to noncompliance issues identified by the Office of the Inspector General. Choice "d" is incorrect. OMB Circular A-133 relates to the financial and compliance audits of major federal financial assistance programs, not to the achievement of program objectives.

QUESTION 449
Gearty & Duffy, certified public accountants, have been engaged to perform an audit of Sleepy Knoll Township in accordance with OMB Circular A-133. In connection with that engagement, Gearty & Duffy will determine major programs:

A. Using a list of programs included in the work plan of the Office of the Inspector General.
B. By applying only a specific dollar threshold, where all programs exceeding the threshold would be considered major.

C. By applying a risk-based approach.
D. By testing enough grants to achieve a single specific coverage percentage.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. OMB Circular A-133 allows auditors to use a risk-based approach to determine major grants.
Choice "a" is incorrect. The judgment of the Office of the Inspector General would not exclusively influence the selection of major programs.
Choice "b" is incorrect. Programs in excess of $300,000 are generally considered to be major grants; however, the dollar threshold is not the exclusive determinant of major programs.
Choice "d" is incorrect. Risk-based auditing allows auditors to test as little as 25 percent of total federal programs or as much as 50 percent of total federal programs, depending on circumstances and on the auditor's judgment.

QUESTION 450
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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. When auditing an entity's financial statements in accordance with Government Auditing Standards, an auditor is required to report on the scope of the auditor's testing of internal control, but not on noteworthy accomplishments of the program.
Choices "a", "c", and "d" are incorrect, based on the above .

QUESTION 451
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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. When auditing an entity's financial statements in accordance with Government Auditing Standards, an auditor is required to report on the scope of the auditor's testing of compliance with laws and regulations, but not on recommendations for actions to improve operations.
Choices "a", "c", and "d" are incorrect based on the above .

QUESTION 452
Which of the following statements represents a quality control requirement under Government Auditing Standards?

A. A CPA who conducts government audits is required to undergo an annual external quality control review when an appropriate internal quality control system is not in place.
B. A CPA seeking to enter into a contract to perform an audit should provide the CPA's most recent external quality control review report to the party contracting for the audit.
C. An external quality control review of a CPA's practice should include a review of the audit documentation for each government audit performed since the prior external quality control review.
D. A CPA who conducts government audits may not make the CPA's external quality control review report available to the public.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:

Section: Volume E

Choice "b" is correct. Audit organizations seeking to enter into a contract to perform an audit in accordance with government auditing standards should provide their most recent external quality control review report to the party contracting for the audit.
Choice "a" is incorrect. Each audit organization conducting audits in accordance with governmental auditing standards should have an appropriate internal quality control system in place and undergo an external quality control review. Choice "c" is incorrect. It is not necessary to review all government audits performed since the last external quality control review. Reviewers should select audits that provide a reasonable cross-section of engagements performed since the last review.
Choice "d" is incorrect. It is recommended that the report be made available to the public.

QUESTION 453
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 the significant deficiencies (reportable conditions) are deemed to be material weaknesses.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. When reporting under Government Auditing Standards, the auditor should consider whether any noted deficiencies in such internal controls should be reported to specific legislative and regulatory bodies.
Choice "a" is incorrect. The auditor would report significant deficiencies to the audit committee. The auditor is prohibited from disclosing confidential client information to the SEC by the Code of Professional Conduct.
Choice "c" is incorrect. When there is no audit committee, the auditor would report significant deficiencies in the design of the client's internal control to an otherwise formally designated committee with oversight over the financial reporting process, not necessarily to a court-appointed creditors' committee.
Choice "d" is incorrect. The auditor would report significant deficiencies to the audit committee. The auditor is prohibited from disclosing confidential client information to significant shareholders by the Code of Professional Conduct.

QUESTION 454
In reporting on compliance with laws and regulations during a financial statement audit in accordance with Government Auditing Standards, an auditor should include in the auditor's report:

A. A statement of assurance that all controls over fraud and illegal acts were tested.
B. Material instances of fraud and illegal acts that were discovered.
C. The materiality criteria used by the auditor in considering whether instances of noncompliance were significant.
D. An opinion on whether compliance with laws and regulations affected the entity's goals and objectives.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Only material instances of fraud and illegal acts discovered need to be communicated in the auditor's report on compliance. If applicable, the report should state that other instances of noncompliance were communicated to management in a separate letter.
Choice "a" is incorrect. The report would state that consideration of internal control over compliance would not necessarily disclose all significant deficiencies (reportable conditions). Not only would there be no assurance that all controls were tested, the auditor would assert the exact opposite.
Choice "c" is incorrect. The auditor would not disclose the materiality criteria used in considering whether instances of noncompliance were significant. Choice "d" is incorrect. The auditor does not express an opinion on whether the compliance affected the entity's goals and objectives.

QUESTION 455
An auditor was engaged to conduct a performance audit of a governmental entity in accordance with Government Auditing Standards. These standards do not require, as part of this auditor's report:

A. A statement of the audit objectives and a description of the audit scope.
B. Indications or instances of illegal acts that could result in criminal prosecution discovered during the audit.
C. The pertinent views of the entity's responsible officials concerning the auditor's findings.
D. A concurrent opinion on the financial statements taken as a whole.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. A concurrent opinion on the financial statements taken as a whole is not a required part of the auditor's report.

Choice "a" is incorrect. A statement of the audit objectives and a description of the audit scope are required parts of the auditor's report.
Choice "b" is incorrect. The auditor would provide indications of illegal acts discovered during the audit.
Choice "c" is incorrect. The pertinent views of the entity's responsible officials concerning the auditor's findings are generally part of the auditor's report.

QUESTION 456
For an entity that does financial statements generally would not refer to:

A. Significant estimates made by management.
B. An assessment of the entity's accounting principles.
C. Management's responsibility for the financial statements.
D. The entity's internal control.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The auditor's standard report does not refer to the entity's internal control.
Choice "a" is incorrect. The auditor's standard report refers to "significant estimates made by management" in the scope paragraph.
Choice "b" is incorrect. The auditor's standard report refers to "assessments of the entity's accounting principles" in the scope paragraph.
Choice "c" is incorrect. The auditor's standard report states management's responsibility for the financial statements in the introductory paragraph.

QUESTION 457
Because of the pervasive effects of laws and regulations on the financial statements of governmental units, an auditor should obtain written management representations acknowledging that management has:

A. Identified and disclosed all laws and regulations that have a direct and material effect on its financial statements.
B. Implemented internal controls designed to detect all illegal acts.
C. Expressed both positive and negative assurance to the auditor that the entity complied with all laws and regulations.
D. Employed internal auditors who can report their findings, opinions, and conclusions objectively without fear of political repercussion.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:

Section: Volume E

Choice "a" is correct. The auditor should obtain written representation that management has disclosed all laws and regulations that have a direct and material effect on its financial statements. Choice "b" is incorrect. Management need not acknowledge that it has implemented internal control activities to detect all illegal acts. Choice "c" is incorrect. Management should state that it is responsible for compliance with all laws and regulations. Choice "d" is incorrect. Management need not employ internal auditors.

QUESTION 458
Which of the following is a 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. Audit documentation should contain sufficient information so that supplementary oral s are not required.
C. The auditor should document the procedures that assure discovery of all illegal acts and contingent liabilities resulting from noncompliance.
D. Audit documentation should contain a caveat that all instances of material errors and fraud may not be identified.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Per Government Auditing Standards, audit documentation should contain sufficient information so that supplementary oral s are not required.
Choice "a" is incorrect. The auditor should obtain written representation from management acknowledging responsibility for "violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency."
Choice "c" is incorrect. The auditor should document procedures performed to evaluate compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts. Choice "d" is incorrect. There is no such requirement that audit documentation contain this caveat.

QUESTION 459
When auditing an entity's financial statements in accordance with Government Auditing Standards, an auditor should prepare a written report on the auditor's:

A. Identification of the causes of performance problems and recommendations for actions to improve operations.
B. Understanding of internal control and assessment of control risk.
C. Field work and procedures that substantiated the auditor's specific findings and conclusions.
D. Opinion on the entity's attainment of the goals and objectives specified by applicable laws and regulations.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Government Auditing Standards require that the auditor issue a written report on internal control in all audits. As part of this reporting requirement, the auditor must describe the scope of the auditor's work in obtaining an understanding of internal control and his or her assessment of control risk.
Choice "a" is incorrect. In the report, the auditor would identify significant deficiencies (reportable conditions) and material weaknesses (not performance problems) found in the examination of the entity's internal control.
Choice "c" is incorrect. A report on fieldwork and procedures that substantiated the auditor's specific findings and conclusions would not be prepared as part of a GAGAS audit.
Choice "d" is incorrect. The objective of the audit of the financial statements is to provide an opinion on the financial statements, not on the entity's attainment of goals and objectives.

QUESTION 460
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 tests of compliance with laws and regulations that have a direct and material effect on the financial statements is part of obtaining reasonable assurance that the financial statements are free of material misstatement.
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.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Basic elements of a report on compliance include a statement that tests of compliance with laws, regulations, contracts, and grants that have a direct and material effect on the financial statements is part of obtaining reasonable assurance that the financial statements are free of material misstatement.
Choice "b" is incorrect. It is not necessary to describe the laws and regulations with which the entity must comply.
Choice "c" is incorrect. The objective of the audit of the financial statements is not to provide an opinion on overall compliance with laws and regulations. Choice

"d" is incorrect. While the auditor does not possess legal skills and cannot make legal judgments, it is not necessary to disclose this in the report.

QUESTION 461
Reporting on internal control under Government Auditing Standards differs from reporting under generally accepted auditing standards in that Government Auditing Standards requires a:

A. Written report describing the entity's internal controls specifically designed to prevent fraud, abuse, and illegal acts.
B. Report describing the scope of the auditor's testing of compliance and of internal control.
C. Statement of negative assurance that internal controls not tested have an immaterial effect on the entity's financial statements.
D. Statement of positive assurance that internal controls designed to detect material errors and fraud were tested.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Government Auditing Standards require a description of the scope of the auditor's testing of compliance and of internal control. This is not required under generally accepted auditing standards.
Choice "a" is incorrect. Although a written report on internal control is required, the auditor does not have to identify procedures specifically designed to prevent fraud, abuse, and illegal acts.
Choice "c" is incorrect. Government Auditing Standards require tests of compliance with applicable laws and regulations governing a particular grant, because the grant money received can only be spent for certain purposes. However, neither GAGAS nor GAAS requires that negative assurance be given with respect to internal controls.
Choice "d" is incorrect. Although Government Auditing Standards require tests of compliance with applicable laws and regulations governing a particular grant (the grant money received can only be spent for certain purposes), auditors are not required to give positive assurance that internal controls designed to detect material errors and fraud were tested under either GAGAS or GAAS.

QUESTION 462
The scope of audits of recipients of federal financial assistance in accordance with federal audit regulations varies. Which of the following elements do these audits have in common?

A. The auditor is required to disclose all situations and transactions that could be indicative of fraud, abuse, and illegal acts to the federal inspector general.
B. The materiality levels are higher and are determined by the government entities that provide the federal financial assistance to the recipients.
C. The auditor is required to document an understanding of internal control established to ensure compliance with the applicable laws and regulations.
D. The accounts should be 100% verified by substantive tests because certain statistical sampling applications are not permitted.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Auditors engaged to perform audits of federal financial assistance (generally under the provisions of the Single Audit Act) must perform procedures to obtain an understanding of internal control pertaining to compliance, and should document this understanding of internal control.
Choice "a" is incorrect. The auditor is required to disclose actual instances of fraud and illegal acts, not all situations that could be indicative of fraud, abuse, or illegal acts.
Choice "b" is incorrect. Materiality levels of organizations receiving federal financial assistance are set by the auditor, not the government. Materiality levels depend upon auditor judgment and will not fall or rise purely as a result of federal participation.
Choice "d" is incorrect. Statistical sampling applications are permitted, and 100% verification of accounts is not required.

QUESTION 463
An enterprise engaged a CPA to audit its financial statements in accordance with Government Auditing Standards (the Yellow Book) because of the provisions of government grant funding agreements. Under these circumstances, the CPA is required to report on the enterprise's internal controls either in the report on the financial statements or in:

A. The report on the performance audit.
B. The notes to the financial statements.
C. A letter to the government funding agency.
D. A separate report.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The report on the audit of the financial statements should describe the scope of the auditor's testing of compliance with laws and regulations and internal control over financial reporting, and should either present the results of those tests or refer to a separate report containing that information.
Choice "a" is incorrect. The CPA was engaged to audit financial statements in accordance with the Yellow Book, not to perform a performance audit.
Choice "b" is incorrect. The notes to the financial statements are a management representation and would not be used by the CPA to comply with requirements to either report or opine in conformity with Yellow Book requirements.

Choice "c" is incorrect. Governmental Auditing Standards require that the auditor describe the scope of the auditor's testing of compliance with laws and regulations and internal control over financial reporting and present the results of those tests as part of their report or in a separate report, not simply in a letter to the funding agency.

QUESTION 464
Reporting standards for financial audits under Government Auditing Standards (the Yellow Book) differ from reporting under generally accepted auditing standards in that Government Auditing Standards require the auditor to:

A. Provide positive assurance that control activities regarding segregation of duties are consistent with the entity's control objectives.
B. Present the results of the auditor's tests of controls.
C. Provide negative assurance that the auditor discovered no evidence of intentional override of internal controls.
D. Describe the scope of the auditor's principal substantive tests.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The report on the audit of financial statements should describe the scope of the auditor's testing of compliance with laws and regulations and internal control over financial reporting, and present the results of those tests.
Choice "a" is incorrect. The auditor's report on internal controls indicates whether or not material weaknesses were found, but it does not provide assurance that specific internal control activities are consistent with the entity's objectives. Choice "c" is incorrect. The auditor is not required to provide negative assurance regarding the override of internal control, although the audit report will provide negative assurances regarding internal control over financial reporting and its operations that may involve a material weakness.
Choice "d" is incorrect. There is no requirement that the auditor describe the scope of substantive tests. However, under Government Auditing Standards, the report on the audit of financial statements should describe the scope of the auditor's testing of compliance with laws and regulations and internal control over financial reporting. Communication with Those Charged with Governance

QUESTION 465
Which of the following matters would an auditor most likely communicate to those charged with governance?

A. A list of negative trends that may lead to working capital deficiencies and adverse financial ratios.
B. The level of responsibility assumed by management for the preparation of the financial statements.
C. Difficulties encountered in achieving a satisfactory response rate from the entity's customers in confirming accounts receivables.
D. The effects of significant accounting policies adopted by management in emerging areas for which there is no authoritative guidance.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The auditor should communicate the initial selection of, and changes in, significant accounting policies to those charged with governance.
Choice "a" is incorrect. Negative trends and adverse financial ratios are evaluated by an auditor when considering an entity's ability to continue as a going concern. These trends and ratios are not required to be communicated to those charged with governance.
Choice "b" is incorrect. The auditor's communications to those charged with governance include the level of responsibility that the auditor is assuming regarding matters of interest to those charged with governance, not the level of responsibility assumed by management.
Choice "c" is incorrect. The auditor is required to inform the audit committee about difficulties encountered with management during the audit. Difficulties encountered in achieving a satisfactory response rate from the entity's customers in confirming accounts receivables generally would not be communicated to those charged with governance, since such difficulties are not related to management.

QUESTION 466
In identifying matters for communication with those charged with governance, 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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The auditor is required to communicate to those charged with governance regarding certain matters, including management consultation with other auditors. Consequently, the auditor must ask management about this matter.
Choice "a" is incorrect. Unusually high turnover in the accounting department is a negative factor in assessing control risk, but it is not a matter that needs to be communicated to those charged with governance.
Choice "c" is incorrect. Inquiry of management concerning any subsequent events of which the auditor is unaware is a required audit procedure, which would also be confirmed as part of the management representation letter, but it is not a matter that needs to be communicated to those charged with governance. (They should already know!)

Choice "d" is incorrect. The auditor alone has responsibility for judgments regarding the assessed level of control risk, and the auditor would not generally discuss this assessment with management.

QUESTION 467
An auditor would least likely initiate a discussion with those charged with governance 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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements. Materiality assessments are not typically discussed with those charged with governance.
Choice "a" is incorrect. The auditor should communicate with those charged with governance about the appropriateness of significant accounting policies, such as the methods used to account for significant unusual transactions.
Choice "c" is incorrect. The auditor should inform those charged with governance of illegal acts that come to the auditor's attention during the course of the audit. Fraud involving senior management should also be reported directly to those charged with governance.
Choice "d" is incorrect. The auditor should discuss with those charged with governance any disagreements with management, whether or not they were satisfactorily resolved, about matters that individually or in the aggregate could be significant to the entity's financial statements or the auditor's report.

QUESTION 468
Which of the following statements is correct concerning an auditor's required communication with those charged with governance?

A. This communication is required to occur before the auditor's report on the financial statements is issued.
B. This communication should include management changes in the application of significant accounting policies.
C. Any significant matter communicated to those charged with governance 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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The auditor should determine that those charged with governance are informed about the initial selection of and changes in significant accounting policies or their application.
Choice "a" is incorrect. The communication is incidental to the audit; accordingly, it is not required to occur before the issuance of the auditor's report as long as the communication occurs on a timely basis. (Note, however, that for audits of issuers, the communication must be made before the auditor's report is filed with the SEC.) Choice "c" is incorrect. Communication with management is not required.
Choice "d" is incorrect. Unless all those charged with governance are also involved with managing the entity, the auditor should inform those charged with governance about adjustments that could, either individually or in the aggregate, have a significant effect on the entity's financial reporting process, regardless of whether the adjustment was recorded.

QUESTION 469
Which of the following matters is an auditor required to communicate to those charged with governance?

A. The basis for his or her assessment of control risk.
B. The process used by management in formulating sensitive accounting estimates.
C. The auditor's preliminary judgments about materiality levels.
D. The justification for performing substantive procedures at interim dates.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. The auditor should ensure that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of the estimates.
Choices "a", "c", and "d" are incorrect. The basis for assessing control risk, preliminary judgments about materiality levels, and the justification for performing substantive procedures at interim dates are matters of auditor judgment that need not be shared with those charged with governance.

QUESTION 470
Which of the following matters is an auditor not required to communicate to those charged with governance?

A. Significant adjustments arising from the audit that were recorded by management.

B. The basis for the auditor's conclusions about the reasonableness of management's sensitive accounting estimates.
C. The level of responsibility assumed by the auditor under generally accepted auditing standards.
D. The degree of reliance the auditor placed on the management representation letter.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The auditor is not required to communicate to those charged with governance the degree of reliance placed on the management representation letter.
Choice "a" is incorrect. Unless all those charged with governance are also involved with managing the entity, the auditor should inform those charged with governance about adjustments arising from the audit, regardless of whether or not management recorded them.
Choice "b" is incorrect. The auditor should communicate qualitative aspects of the process used by management in formulating sensitive accounting estimates, which would likely include discussion of the basis for the auditor's conclusions regarding the reasonableness of those estimates.
Choice "c" is incorrect. The auditor should communicate the level of responsibility that he/she is assuming under GAAS.

QUESTION 471
An auditor's communication with those charged with governance is required to include the:

A. Basis for the auditor's preliminary judgment about materiality.
B. Justification for the auditor's selection of sampling methods.
C. Discussion of disagreements with management about matters that significantly impact the entity's financial statements.
D. Assessment of the quality of the entity's earnings as compared to the previous year.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. The auditor should discuss with those charged with governance any significant disagreements with management, whether or not satisfactorily resolved, about matters that are significant to the financial statements or to the auditor's report.
Choices "a" and "b" are incorrect. There is no requirement that the auditor's communication with those charged with governance include a justification for any of

the judgments made in conducting the audit.
Choice "d" is incorrect. An auditor of an SEC client is required to discuss his or her judgment about the quality of the entity's accounting principles and estimates, not the quality of the entity's earnings. Note too that this requirement does not apply to non-SEC clients, and that no comparison to prior year is required.

QUESTION 472
Which of the following matters is an auditor required to communicate to those charged with governance?

A. Adjustments that were suggested by the auditor and recorded by management that have a significant effect on the entity's financial reporting process.
B. The auditor's consideration of risk factors in assessing the risk of material misstatement arising from the misappropriation of assets.
C. The results of the auditor's analytical procedures performed in the review stage of the engagement that indicate significant variances from expected amounts.
D. Changes in the auditor's preliminary judgment about materiality that were caused by projecting the results of statistical sampling for tests of transactions.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The auditor is required to communicate significant audit findings to those charged with governance. Significant audit findings include material, corrected misstatements brought to management's attention as a result of the audit. Unless all of those charged with governance are also involved with managing the entity, such findings should be communicated by the auditor.
Choice "b" is incorrect. The auditor is not required to communicate with those charged with governance regarding his/her fraud risk assessment.
Choice "c" is incorrect. The auditor is not required to communicate with those charged with governance regarding the results of specific audit procedures.
Choice "d" is incorrect. The auditor is not required to communicate with those charged with governance regarding changes to his/her preliminary judgment about materiality.

QUESTION 473
Which of the following should be included as a written representation from management?

A. The belief that misstatements identified by the auditor and not corrected are immaterial.
B. The belief that misstatements identified by the auditor and corrected are material.
C. The belief that the auditor is responsible for the fair presentation of the financial statements in conformity with generally accepted accounting principles.
D. The belief that the financial statements are completely accurate in all respects.

Correct Answer: A
Section: Volume E

Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The representation letter should include management's belief that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
Choice "b" is incorrect. If the misstatements have been corrected, there is no need for management to make representations regarding their materiality.
Choice "c" is incorrect. Management (and not the auditor) is responsible for the fair presentation of the financial statements in conformity with generally accepted accounting principles.
Choice "d" is incorrect. Management states its belief that the financial statements are fairly presented in conformity with GAAP. Fair presentation does not mean that the financial statements are completely accurate in all respects, but that they are accurate in all material respects.

QUESTION 474
"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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. The statement concerning communications with regulatory agencies is made by management to the auditor as written confirmation of a matter for which corroborating evidence can only be obtained from inquiry of management. The statement would appear in the management representation letter.
Choice "a" is incorrect. As a representation of management, the statement concerning communications with regulatory agencies would not appear in the auditor's report on internal control.
Choice "b" is incorrect. As a representation of management, the statement concerning communications with regulatory agencies would not appear in the auditor's special report. Choice "d" is incorrect. A statement concerning communications with regulatory agencies generally would not appear in an auditor's letter for underwriters.

QUESTION 475
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.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding of the limits of materiality for this purpose. Such limitations would not apply to those representations that are not directly related to amounts included in the financial statements, such as management's acknowledgment of its responsibility for the financial statements, availability of financial records, and completeness and availability of minutes.
Choice "b" is incorrect. Losses from purchase commitments are directly related to amounts in the financial statements and thus are subject to materiality limits.
Choice "c" is incorrect. The disclosure of compensating balances is directly related to amounts in the financial statements and thus is subject to materiality limits.
Choice "d" is incorrect. The reduction of obsolete inventory to net realizable value is directly related to amounts in the financial statements and thus is subject to materiality limits.

QUESTION 476
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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:

Section: Volume E

Choice "c" is correct. Because the auditor is concerned with events occurring through the date of the audit report that may require adjustment to or disclosure in the financial statements, the management representation letter should be dated as of the date of the auditor's report.
Choice "a" is incorrect. The management representation letter is dated as of the date of the auditor's report, which is generally after the balance sheet date.
Choice "b" is incorrect. The management representation letter is dated as of the date of the auditor's report, which is unrelated to the date of the latest interim financial information. Choice "d" is incorrect. The management representation letter is dated as of the date of the auditor's report, which is unrelated to the dates of related party transactions.

QUESTION 477
"There are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency." The foregoing passage most likely is from a (an):

A. Client engagement letter.
B. Report on compliance with laws and regulations.
C. Management representation letter.
D. Attestation report on internal control.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. The written representation obtained by the auditor from management will ordinarily include information regarding any violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
Choice "a" is incorrect. A client engagement letter is used to document the understanding between the client and the auditor. The letter is generally sent from the auditor to the client, although the client may be requested to sign it. The statement, "There are no violations or possible violations of laws or regulations..." should come from management. It would not be appropriate to include this in an engagement letter, which is often sent before the year has even ended.
Choice "b" is incorrect. An auditor would prepare a report on compliance with laws and regulations. The statement, "There are no violations or possible violations of laws or regulations..." should come from management. Choice "d" is incorrect. An auditor would prepare an attestation report on internal control. The statement, "There are no violations or possible violations of laws or regulations..." should come from management.

QUESTION 478
Which of the following statements might be included among additional 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 internal control.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The purpose of the management representation letter is to confirm management's oral evidence supplied during the engagement. Specific written representations obtained by the auditor might include acknowledgment that all compensating balances or other restrictions on cash have been disclosed. Choice "b" is incorrect. Management acknowledges responsibility for the fair presentation of the financial statements, not for illegal actions committed by employees.
Choice "c" is incorrect. The auditor must decide whether there is sufficient audit evidence available to permit the issuance of an unqualified opinion, and does not request management confirmation of this decision. Choice "d" is incorrect. Management is responsible for the design and maintenance of internal control of the company, but it is the auditor who must determine whether material weaknesses in internal control exist.

QUESTION 479
Which of the following factors most likely would cause an auditor to question-the integrity of management?

A. Management has an aggressive attitude toward financial reporting and meeting profit goals.
B. Audit tests detect material fraud that was known to management, but not disclosed to the auditor.
C. Managerial decisions are dominated by one person who is also a stockholder.
D. Weaknesses in internal control reported to the audit committee are not corrected by management.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Management is required to disclose all material matters to the independent auditor, including information concerning material fraud. This disclosure is so important that it is included in writing, in the management representation letter. Failure of management to disclose material fraud to the auditor would cause the auditor to question-management's integrity and perhaps even to withdraw from the engagement.

Choice "a" is incorrect. While management's aggressive attitude certainly constitutes a fraud risk, this alone would not necessarily cause the auditor to question-management's integrity. It is possible for management to be both aggressive and ethical.
Choice "c" is incorrect. While the domination of management by a stockholder certainly constitutes a fraud risk, this alone would not necessarily cause the auditor to question-management's integrity. It is possible for management to be an ethical shareholder.
Choice "d" is incorrect. Failure to correct a known weakness in internal control may be a conscious decision based on the cost and benefit involved with making the correction. Such decisions do not imply that management lacks integrity.

QUESTION 480
Which of the following expressions most likely would be included in a management representation letter?

A. No events have occurred subsequent to the balance sheet date that require adjustment to, or disclosure in, the financial statements.
B. There are no significant deficiencies in internal control identified during the prior-year's audit of which those charged with governance are unaware.
C. We do not intend to provide any information that may be construed to constitute a waiver of the attorney-client privilege.
D. Certain computer files and other required audit evidence may exist only for a short period of time and only in computer-readable form.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. It is appropriate for the representation letter to contain a statement regarding subsequent events.
Choice "b" is incorrect. The representation letter typically includes information in four categories: financial statements; completeness; recognition, measurement, and disclosure; and subsequent events. The communication of significant deficiencies in internal control does not fall within these categories.
Choice "c" is incorrect. The representation letter typically includes information in four categories: financial statements; completeness; recognition, measurement, and disclosure; and subsequent events.
A waiver of attorney-client privilege does not fall within these categories.
Choice "d" is incorrect. While this may be an accurate statement, it is not something that would be included in the management representation letter. The representation letter typically includes information in four categories: financial statements; completeness; recognition, measurement, and disclosure; and subsequent events.

QUESTION 481
Which of the following procedures should an auditor perform concerning litigation, claims, and assessments?

A. Inspect legal documents in the possession of the client's lawyer that are relevant to pending litigation and unasserted claims and assessments.
B. Discuss with the client's lawyer its philosophy of defending litigation, claims, and assessments that have a high probability of being resolved unfavorably.
C. Confirm directly with the client's lawyer that all litigation, claims, and assessments have been properly recorded in the financial statements.

D. Obtain assurance from management that it has disclosed all unasserted claims that its lawyer has advised are probable of assertion.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The auditor should obtain assurance from management that it has disclosed all unasserted claims that its lawyer has advised are probable of assertion.
Choice "a" is incorrect. The auditor should examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers. The auditor does not generally examine documents held by the client's lawyer.
Choice "b" is incorrect. If the lawyer has indicated that there is a high probability of a litigation, claim, or assessment being resolved unfavorably, the auditor would use this information, together with an estimate of the range of potential loss (if available), to evaluate management's financial statement presentation. The auditor would not generally discuss with the client's lawyer its defense philosophy regarding such matters.
Choice "c" is incorrect. It is the auditor's responsibility (not the lawyer's) to determine whether litigation, claims, and assessments have been adequately recorded or disclosed in the financial statements.

QUESTION 482
Which of the following matters most likely would be included in a management representation letter?

A. An assessment of the risk factors concerning the misappropriation of assets.
B. An evaluation of the litigation that has been filed against the entity.
C. A confirmation that the entity has complied with contractual agreements.
D. A statement that all material internal control weaknesses have been corrected.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. The management representation letter should include information on recognition, measurement, and disclosure, and will generally state that the company has complied with all aspects of contractual agreements that may materially affect the financial statements.
Choice "a" is incorrect. As part of planning the audit, the auditor must assess the risk that misappropriation of assets may occur, and may cause a material misstatement in the financial statements. While management may also assess this risk for its own purposes, the auditor would not be able to rely on

management's assessment, and therefore would not typically request a representation regarding this matter.
Choice "b" is incorrect. The auditor will typically request that the client's attorney evaluate pending litigation, as the attorney is more knowledgeable in such areas than is management.
Choice "d" is incorrect. The management representation letter typically includes information regarding the financial statements, the completeness of information, recognition, measurement, and disclosure, and subsequent events. Representations regarding internal control are not typically included in a management representation letter.

QUESTION 483
Which of the following statements ordinarily is not included among the written client representations made by the chief executive officer and the chief financial officer?

A. "Sufficient audit evidence has been made available to the auditor to permit the issuance of an unqualified opinion."
B. "There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed."
C. "We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities."
D. "No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements."

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The sufficiency of audit evidence and the type of opinion to be rendered are determined by the auditor, who applies professional judgment in making such determinations.
Management representations are not necessary for the auditor to make such judgments, but rather would be used to confirm representations given to the auditor regarding the financial statements, completeness of information, recognition, measurement, and disclosure, and subsequent events.
Choice "b" is incorrect. The management representation letter should include information on recognition, measurement, and disclosure, and will generally state that there are no unasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed.
Choice "c" is incorrect. The management representation letter should include information on recognition, measurement, and disclosure, and will generally state that management has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
Choice "d" is incorrect. The management representation letter should include information on subsequent events, and will generally state that no events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

QUESTION 484
To which of the following matters would materiality limits not apply when obtaining written client representations?

A. Violations of state labor regulations.
B. Disclosure of line-of-credit arrangements.

C. Information about related party transactions.
D. Instances of fraud involving management.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Materiality limits do not apply to client representations involving management fraud.
The management representation letter generally indicates that "there has been no fraud involving management" (without reference to materiality). The only mention of material fraud relates to situations involving parties other than management.
Choice "a" is incorrect. Materiality limits do apply to violations of state labor regulations. The management representation letter generally indicates that there are no violations of regulations "whose effects should be considered for financial statement disclosure"--and only material effects would typically be considered for disclosure.
Choice "b" is incorrect. Since GAAP requires disclosure of material line-of-credit arrangements, materiality limits do apply to representations about such matters.
Choice "c" is incorrect. Since GAAP requires disclosure of material related party transactions, materiality limits do apply to representations about such matters.

QUESTION 485
A written client representation letter most likely would be an auditor's best source of corroborative information of a client's plans to:

A. Terminate an employee pension plan.
B. Make a public offering of its common stock.
C. Settle an outstanding lawsuit for an amount less than the accrued loss contingency.
D. Discontinue a line of business.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. A written client representation letter should include representations regarding matters that may affect recognition, measurement, and disclosure. Management's plans to discontinue a line of business may affect financial statement disclosure, since the results of operations of a component classified as "held for sale" would be reported separately in the income statement under "discontinued operations." Choice "a" is incorrect. A client's plan to

terminate an employee pension plan would not affect recognition, measurement, or disclosure in the current period financial statements.
Choice "b" is incorrect. A client's plans to make a public offering of its common stock would not affect recognition, measurement, or disclosure in the current period financial statements.
Choice "c" is incorrect. A letter from the client's attorney most likely would be an auditor's best source of corroborative information of a client's plans to settle an outstanding lawsuit for an amount less than the accrued loss contingency.

QUESTION 486
A limitation on the scope of an auditor's examination sufficient to preclude an unqualified opinion will always result when management:

A. Engages the auditor after the year-end physical inventory count is completed.
B. Fails to correct a material internal control weakness that had been identified during the prior year's audit.
C. Refuses to furnish a management representation letter to the auditor.
D. Prevents the auditor from reviewing the audit documentation of the predecessor auditor.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Management's refusal to furnish a written representation letter constitutes a limitation on the scope sufficient to preclude an unqualified opinion.
Choice "a" is incorrect. Engaging the auditor after the year-end physical count is completed need not preclude an unqualified opinion if the auditor can apply satisfactory alternative audit procedures.
Choice "b" is incorrect. Failure to correct a material internal accounting control weakness that had been identified during the prior year's audit need not preclude an unqualified opinion, although it may require the auditor to apply extended auditing procedures.
Choice "d" is incorrect. Inability to review the predecessor's prior year audit documentation may cause the successor auditor more work but need not preclude an unqualified opinion in the current year.

QUESTION 487
To which of the following matters would an auditor not apply materiality limits when obtaining specific written client representations?

A. Disclosure of compensating balance arrangements involving restrictions on cash balances.
B. Information concerning related party transactions and related amounts receivable or payable.
C. The absence of errors and unrecorded transactions in the financial statements.
D. Fraud involving employees with significant roles in the internal control structure.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. When obtaining specific written client representations, an auditor would not apply materiality limits to fraud involving employees with significant roles in the internal control structure, because even fraud that causes an immaterial effect on the financial statements may have serious implications with respect to the integrity of the employees involved.
Choice "a" is incorrect. An auditor would apply materiality limits when obtaining specific written client representations pertaining to disclosure of compensating balance arrangements involving restrictions on cash balances, because immaterial amounts need not be considered.
Choice "b" is incorrect. An auditor would apply materiality limits when obtaining specific written client representations pertaining to information concerning related party transactions and related amounts receivable or payable, because immaterial amounts need not be considered.
Choice "c" is incorrect. An auditor would apply materiality limits when obtaining specific written client representations pertaining to the absence of errors and unrecorded transactions in the financial statements, because immaterial amounts need not be considered.

QUESTION 488
"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. Special report.
B. Management representation letter.
C. Letter for an underwriter.
D. Report on internal controls.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. In a management (client) representation letter, the client will generally confirm that there have been no communications from regulatory agencies concerning matters that could have a material effect on the financial statements.
Choice "a" is incorrect. A passage regarding communications from regulatory agencies generally will not be found in a special report.
Choice "c" is incorrect. A passage regarding communications from regulatory agencies generally will not be found in a letter for an underwriter (i.e., a comfort letter). Choice "d" is incorrect. A passage regarding communications from regulatory agencies generally will not be found in a report on internal controls.

QUESTION 489
To which of the following matters would materiality limits not apply when obtaining written client representations?

A. Losses from sales commitments.
B. Unasserted claims and assessments.
C. Fraud involving management.
D. Noncompliance with contractual agreements.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Materiality limits would not apply when obtaining written client representations regarding irregularities involving management, because even immaterial instances of fraud may have serious implications with respect to management's integrity.
Choices "a", "b", and "d" are incorrect. An auditor would apply materiality limits to matters that might affect recognition, measurement, and disclosure in the financial statements, including losses from sales commitments, unasserted claims and assessments, and noncompliance with contractual agreements.

QUESTION 490
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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. A purpose of a management representation letter is to reduce the possibility of a misunderstanding concerning management's responsibility

for the financial statements. The first representation made in the letter states "we are responsible for the fair presentation in the financial statements of financial position, results of operations and cash flows in conformity with GAAP."
Choice "a" is incorrect. The management representation letter confirms oral representations made by management but does not have an effect on audit risk.
Choice "b" is incorrect. The management letter is important audit evidence but it does not reduce the auditor's responsibility to detect material misstatements.
Choice "d" is incorrect. The management letter is important audit evidence but it does not reduce the scope of an auditor's procedures concerning related party transactions and subsequent events (or any other generally accepted audit procedure).

QUESTION 491
Which of the following matters is an auditor required to communicate to those charged with governance?

	Significant audit adjustments	Changes in significant accounting policies
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Yes - Yes. Unless all of those charged with governance are also involved with managing the entity, the auditor is required to communicate significant audit adjustments. The auditor is always required to communicate changes in significant accounting policies.
Choices "b", "c", and "d" are incorrect, based on the above .

QUESTION 492

Should an auditor communicate the following matters to those charged with governance of a public entity?

	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

A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Unless all of those charged with governance are also involved with managing the entity, significant audit adjustments and significant matters relating to consultation with other accountants should be communicated to those charged with governance.
Choices "b", "c", and "d" are incorrect, based on the above .

QUESTION 493
Which of the following statements is correct concerning an auditor's required communication with those charged with governance?

A. This communication should include disagreements with management about significant audit adjustments, whether or not satisfactorily resolved.
B. If matters are communicated in writing, the report is appropriate for general use.

C. If matters are communicated in writing, the report is required to be distributed to both those charged with governance and management.
D. This communication is required to occur before the auditor's report on the financial statements is issued.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. An auditor is required to communicate certain matters to those charged with governance, including disagreements with management about significant audit adjustments, whether or not satisfactorily resolved.
Choice "b" is incorrect. Written communications should include a limitation on the use of the communication.
Choice "c" is incorrect. The auditor is not required to distribute the report to management, especially since certain matters might be inappropriate for discussion with management.
Choice "d" is incorrect. The auditor is not required to make the communication before the auditor's report on the financial statements is finalized, as long as the communication occurs on a timely basis. (Note, however, that for audits of issuers, the communication must be made before the auditor's report is filled with the SEC.)

QUESTION 494
During consideration of internal control in a financial statement audit, an auditor is not obligated to:

A. Search for all significant deficiencies in the operation of internal control.
B. Understand the internal control environment and the accounting system.
C. Determine whether the control activities relevant to audit planning have been implemented.
D. Perform procedures to understand the design of internal control.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. During consideration of internal control in a financial statement audit, an auditor is not obligated to search for all significant deficiencies in the operation of internal control, but should communicate any such situations noted to management and those charged with governance.
Choice "b" is incorrect. The auditor is required to obtain an understanding of each of the five components of internal control, including the control environment

and the (accounting) information system. Choices "c" and "d" are incorrect. As part of planning, the auditor is required to obtain an understanding of the design of relevant controls and to determine whether they have been implemented.

QUESTION 495
A principal advantage of statistical methods of attribute sampling over nonstatistical methods is that they provide a scientific basis for planning the:

A. Risk of overreliance.
B. Tolerable rate.
C. Expected population deviation rate.
D. Sample size.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. A principal advantage of statistical methods of attribute sampling over nonstatistical methods is that they provide a scientific basis for planning the sample size.
Choices "a", "b", and "c" are incorrect. The risk of overreliance, the tolerable rate, and the expected population deviation rate are factors considered in determining a statistical sample size.

QUESTION 496
When planning a sample for a substantive test of details, an auditor should consider tolerable misstatement for the sample. This consideration should:

A. Be related to the auditor's business risk.
B. Not be adjusted for qualitative factors.
C. Be related to preliminary judgments about materiality levels.
D. Not be changed during the audit process.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Tolerable misstatement is the maximum monetary misstatement in an account balance that may exist without causing the financial statements to be materially misstated. Tolerable misstatement is a planning concept related to the auditor's preliminary judgments about materiality levels.
Choice "a" is incorrect. The auditor's overall business risk is not related to the tolerable misstatement used in planning a sample for a substantive test of details.
Choice "b" is incorrect. The tolerable misstatement should be adjusted for both qualitative and quantitative factors.
Choice "d" is incorrect. The auditor should modify his or her consideration of tolerable misstatement if, during the audit process, information used to determine the initial level of tolerable misstatement changes.

QUESTION 497
Stratified mean per unit (MPU) sampling is a statistical technique that may be more efficient than unstratified MPU because it usually:

A. May be applied to populations where many monetary errors are expected to occur.
B. Produces an estimate having a desired level of precision with a smaller sample size.
C. Increases the variability among items in a stratum by grouping sampling units with similar characteristics.
D. Yields a weighted sum of the strata standard deviations that is greater than the standard deviation of the population.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. A stratified sample generally is more efficient than an unstratified sample since the population is classified in a manner that emphasizes the higher dollar value items. The result is an estimate having a desired level of precision with a smaller sample size.
Choice "a" is incorrect. Both stratified and unstratified MPU may be used for populations where many monetary errors are expected to occur. Choice "c" is incorrect. Stratified sampling reduces the variability among items in a stratum.
Choice "d" is incorrect. Standard deviations measure variability, and stratification would tend to reduce the strata standard deviations as compared to the overall standard deviation of the population.

QUESTION 498
To determine the sample size for a test of controls, an auditor should consider the tolerable deviation rate, the allowable risk of assessing control risk too low, and the:

A. Expected deviation rate.
B. Upper deviation rate.
C. Risk of incorrect acceptance.
D. Risk of incorrect rejection.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. When determining the sample size for a test of controls, the auditor should consider the expected deviation rate (which is the auditor's best estimate of the deviation rate in the population before the sampling plan is executed), the tolerable deviation rate, and the allowable risk of assessing control risk too low.
Choice "b" is incorrect. The upper deviation rate is used to evaluate a balance after a sampling plan has been performed, not to determine the sample size for a test of controls.
Choices "c" and "d" are incorrect. The risk of incorrect acceptance and risk of incorrect rejection are considered in direct tests of balances (i.e., substantive tests), not in tests of controls.

QUESTION 499
Which of the following statements is correct concerning probability proportional to size (PPS) sampling, also known as dollar unit sampling?

A. The sampling distribution should approximate the normal distribution.
B. Overstated units have a lower probability of sample selection than units that are understated.
C. The auditor controls the risk of incorrect acceptance by specifying that risk level for the sampling plan.
D. The sampling interval is calculated by dividing the number of physical units in the population by the sample size.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. In PPS sampling, the auditor controls the risk of incorrect acceptance by specifying that risk level for the sampling plan. The inputs for PPS are tolerable error, risk of incorrect acceptance, number of errors allowed, and the recorded amount of the population being sampled.
Choice "a" is incorrect. The sampling distribution does not have to approximate the normal distribution in order for PPS sampling to be used.
Choice "b" is incorrect. Overstated units have a higher (not lower) probability of sample selection than units that are understated, because with PPS sampling, each item is given a probability of selection in proportion to its recorded amount (probability-proportional-to-size).
Choice "d" is incorrect. In PPS sampling, the sampling interval is calculated by dividing the recorded amount of the population (not the number of physical units) by the sample size.

QUESTION 500
When using classical variables sampling for estimation, an auditor normally evaluates the sampling results by calculating the possible error in either direction. This statistical concept is known as:

A. Precision.
B. Reliability.
C. Projected error.
D. Standard deviation.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The statistical concept of precision is used to describe the auditor's evaluation of sampling results by calculating the possible error in either direction.
Choice "b" is incorrect. Reliability measures how frequently the procedure used will yield differences between the estimated value and the population value.
Choice "c" is incorrect. Projected error is the auditor's best estimate of the error in the total population based upon evaluating the actual error rate in the sample results. The auditor then adds an allowance for sampling risk to develop a "precision interval" within which the population is expected to fall.
Choice "d" is incorrect. Standard deviation is a measure of the variability of a frequency distribution about its mean.

Group Exam C

QUESTION 1
Which of the following sampling methods would be used to estimate a numerical measurement of a population, such as a dollar value?

A. Discovery sampling.
B. Numerical sampling.
C. Sampling for attributes.
D. Sampling for variables.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Variables sampling is used to estimate a numerical measurement of a population, such as the dollar value or the dollar value of errors in the population.
Choice "a" is incorrect. Discovery sampling is a special case of sampling for "attributes" (errors) where the auditor's initial estimate of error occurrence is zero or near zero. It does not sample for dollar value.
Choice "b" is incorrect. The term "numerical sampling" is not used in statistical sampling and is merely a well-designed distractor.
Choice "c" is incorrect. Attribute sampling is sampling for errors (or some other attribute). The auditor determines whether the attribute appears or not, but does not try to estimate a numerical measurement of the population.

QUESTION 2
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

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

CPA-02882		**Explanation**						
Recorded Amount	−	Audit Amount	=	Tainting Percentage	×	Sample Interval	=	Projected Error
$10,000	−	$8,000	=	N/A		N/A		$2,000

N/A = not applicable, as the actual difference of $2,000 is used when the recorded amount is larger than the sample interval. Choice "b" is correct. There is a $2,000 projected error in this PPS sample. Choices "a", "c", and "d" are incorrect, based on the above .

QUESTION 3
The diagram below depicts the auditor's estimated maximum deviation rate compared with the tolerable rate, and also depicts the true population deviation rate compared with the tolerable rate.

Auditor's estimate based on sample results \ True state of population	Deviation rate is less than tolerable rate	Deviation rate exceeds tolerable rate
Maximum deviation rate is less than tolerable rate	I.	III.
Maximum deviation rate exceeds tolerable rate	II.	IV.

As a result of tests of controls, the auditor assesses control risk higher than necessary and thereby increases substantive testing. This is illustrated by situation:

A. I.
B. II.
C. III.
D. IV.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. If, as a result of test of controls, the auditor assesses control risk higher than necessary, then the maximum deviation rate (auditor's estimate) exceeds the tolerable rate (putting us in row 2) and the deviation rate (true state of the population) is less than the tolerable rate (putting us in column 1). The intersection of column 1 and row 2 puts us in box II.
Choice "a" is incorrect. The auditor estimates that the maximum deviation rate is more than the tolerable rate.
Choice "c" is incorrect. The question-states that the auditor assessed control risk "higher than necessary." This implies that the deviation rate (true state of the population) is actually less than the tolerable rate.
Choice "d" is incorrect. The question-states that the auditor assessed control risk "higher than necessary." This implies that the deviation rate (true state of the population) is actually less than the tolerable rate.

QUESTION 4
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.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. As the auditor's tolerable rate decreases (the auditor cannot accept as large an error rate), the sample size increases and vice-versa. Therefore, there is an inverse relationship between the sample size and the tolerable rate.
Choice "a" is incorrect. Deviations from control procedures at a given rate usually result in misstatements at a lower rate (i.e., not every deviation from an internal control procedure will necessarily result in a misstatement in the financial statements).
Choice "b" is incorrect. When using statistical sampling for tests of controls, changing the size of the population has very little effect on the sample size (unless the population is very small).
Choice "c" is incorrect. Consideration should be given to the qualitative aspects of deviations, including the nature and cause of deviations and the possible relationship of the deviations to other phases of the audit.

QUESTION 5
An auditor may decide to decrease the acceptable level of risk when:

A. Increased reliability from the sample is desired.
B. Many differences (audit value minus recorded value) are expected.

C. Initial sample results do not support the planned level of control risk.
D. The cost and effort of selecting additional sample items is low.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Decreasing the acceptable level of risk will result in a larger sample size, which the auditor might not want to do unless the cost and effort of selecting additional sample items is low.
Choice "a" is incorrect. Decreasing the acceptable level of risk doesn't increase the reliability of a given sample. It does, however, result in selection of a larger sample, which in turn makes it less likely that the auditor will make an incorrect decision.
Choice "b" is incorrect. The auditor's acceptable level of risk is not affected by the extent to which differences are expected.
Choice "c" is incorrect. Control risk is not relevant in assessing the acceptable level of risk, which is a factor of substantive testing.

QUESTION 6
In determining the number of documents to select for a test to obtain assurance that all sales returns 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.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. In determining the number of sample items to select in a test of controls, the auditor would also consider the likely rate of deviations. The higher the expected rate, the greater the number of items selected. Choices "b", "c", and "d" are incorrect. The process of establishing the number of sample items to select in a test of controls would include the consideration of the allowable risk of assessing control risk too low, not too high.

QUESTION 7
With respect to the audit of a nonissuer, significant deficiencies are matters that come to an auditor's attention that should be communicated to an entity's management and those charged with governance because they represent:

A. Manipulation or falsification of accounting records or documents from which financial statements are prepared.
B. Disclosures of information that significantly contradict the auditor's going concern assumption.
C. Material irregularities or illegal acts perpetrated by high-level management.
D. Deficiencies in the design or operation of internal control that could reasonably be expected to cause a non-inconsequential misstatement in the financial statements.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. Significant deficiencies in the design or operation of internal control should be communicated to management and those charged with governance because there is more than a remote likelihood that they will result in a financial statement misstatement that is more than inconsequential.
Choice "a" is incorrect. Manipulation or falsification of accounting records may not represent an internal control deficiency (e.g., if such fraud occurs through collusion).
Choice "b" is incorrect. Information indicative of a going concern problem is not an internal control deficiency.
Choice "c" is incorrect. Irregularities or illegal acts may not represent deficiencies in internal control (e.g., if such acts occur through collusion).

QUESTION 8
Which of the following characteristics distinguishes computer processing from manual processing?

A. Computer processing virtually eliminates the occurrence of computational error normally associated with manual processing.
B. Errors or irregularities in computer processing will be detected soon after their occurrences.
C. The potential for systematic error is ordinarily greater in manual processing than in computerized processing.
D. Most computer systems are designed so that transaction trails useful for audit purposes do not exist.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. Computer processing virtually eliminates the occurrence of (random) computational errors normally associated with manual processing. This is a major benefit of computer processing over manual processing.
Choice "b" is incorrect. Depending on human involvement and review, errors or irregularities in computer processing may not be detected quickly.
Choice "c" is incorrect. The potential for systematic errors (e.g., incorrect programming, incorrect data entry) is greater in a computerized system due to reduced human involvement in processing. Choice "d" is incorrect. Only poorly designed computerized systems provide no audit trail capabilities.

QUESTION 9
The two requirements crucial to achieving audit efficiency and effectiveness with a microcomputer are selecting:

A. The appropriate audit tasks for microcomputer applications and the appropriate software to perform the selected audit tasks.
B. The appropriate software to perform the selected audit tasks and client data that can be accessed by the auditor's microcomputer.
C. Client data that can be accessed by the auditor's microcomputer and audit procedures that are generally applicable to several clients in a specific industry.
D. Audit procedures that are generally applicable to several clients in a specific industry and the appropriate audit tasks for microcomputer applications.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. In microcomputer audit applications, efficient and effective system usage requires:
(1) identification of the appropriate audit tasks and
(2) appropriate software to perform the selected audit tasks.
Choice "b" is incorrect. Although microcomputer access to client data is desirable, it is not required.
Choice "c" is incorrect. Although microcomputer access to client data is desirable, it is not required. Also, microcomputer audit applications need not be applicable to several clients to be efficient and effective. Choice "d" is incorrect. Microcomputer audit applications need not be applicable to several clients to be efficient and effective.

QUESTION 10
With respect to the audit of a nonissuer, significant deficiencies are matters that come to an auditor's attention, which should be communicated to an entity's management and those charged with governance because they represent:

A. Material irregularities or illegal acts perpetrated by high-level management.
B. Deficiencies in the design or operation of internal control that could reasonably be expected to cause a non-inconsequential misstatement in the financial

statements.

C. Flagrant violations of the entity's documented conflict-of-interest policies.
D. Intentional attempts by client personnel to limit the scope of the auditor's fieldwork.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Significant deficiencies in the design or operation of internal control should be communicated to management and those charged with governance because there is more than a remote likelihood that they will result in a financial statement misstatement that is more than inconsequential.
Choice "a" is incorrect. Irregularities or illegal acts may not represent deficiencies in internal control (e.g., if such acts occur through collusion).
Choice "c" is incorrect. Significant deficiencies do not necessarily involve violations of an entity's conflict-of-interest policies.
Choice "d" is incorrect. Interfering with the auditor's procedures would not constitute a significant deficiency, since such interference would not affect the financial statements.

QUESTION 11
An auditor who is testing IT controls in a payroll system would most likely use test data that contain conditions such as:

A. Deductions not authorized by employees.
B. Overtime not approved by supervisors.
C. Time tickets with invalid job numbers.
D. Payroll checks with unauthorized signatures.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Test data often contains invalid information (such as invalid job numbers) that is used to test EDP controls.
Choices "a", "b", and "d" are incorrect. While approvals and authorizations should all be tested, they are not IT controls and would not be tested through use of test data.

QUESTION 12
Which of the following statements most likely represents a disadvantage for an entity that keeps microcomputer-prepared data files rather than manually prepared files?

A. It is usually more difficult to detect transposition errors.
B. Transactions are usually authorized before they are executed and recorded.
C. It is usually easier for unauthorized persons to access and alter the files.
D. Random error associated with processing similar transactions in different ways is usually greater.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. Microcomputer systems are sometimes characterized by weak file and data security, and are usually accessible by many office personnel. (Manual systems, in contrast, generally restrict one user from accessing other users' files.) Thus, it is usually easier (increased risk) for unauthorized persons to access and alter computer system files, especially microcomputer system files.
Choice "a" is incorrect. No difference exists between manual and computer-based systems for detecting transposition errors.
Choice "b" is incorrect. Transactions should always be authorized before they are executed and recorded, in both manual and computer-based systems.
Choice "d" is incorrect. Because computer-based processing imposes strict rules on input and processing, generally there are fewer random processing errors.

QUESTION 13
In a computerized payroll system environment, an auditor would be least likely to use test data to test controls related to:

A. Missing employee numbers.
B. Proper approval of overtime by supervisors.
C. Time tickets with invalid job numbers.
D. Agreement of hours per clock cards with hours on time tickets.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Proper approval of overtime by supervisors is least likely to be used by the auditor in a "test data" test of controls because it is information generally not recorded in the computer.
Choices "a", "c", and "d" are incorrect. Test data is data (with a predetermined result) that is run through the client's computer system. The auditor creates one transaction of each type of valid and invalid conditions in which the auditor is interested and runs them through the client's processing system. The following are recorded in the computer and are likely candidates for "test data" tests of controls.
A. Missing employee numbers.
C. Time tickets with invalid job numbers.
D. Agreement of hours per clock card with hours on time tickets.

QUESTION 14
When engaged to express an opinion on a nonissuer's internal control, an accountant should:

A. Obtain management's written assertions regarding whether the company has maintained effective internal control.
B. Qualify any opinion concerning management's assertion that the cost of correcting any weaknesses exceeds the benefits.
C. Keep informed of events subsequent to the date of the report that might have affected the accountant's opinion.
D. Disclaim an opinion on whether the system taken as a whole is sufficient to prevent or detect material errors or irregularities.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. An auditor should obtain management's written assertion about the effectiveness of the entity's internal control.
Choice "b" is incorrect. The accountant should disclaim (not qualify) an opinion on management's assertions that the cost of correcting weaknesses exceeds the benefits.
Choice "c" is incorrect. The accountant has no responsibility to evaluate the effect of subsequent events. In fact, the report on an entity's internal control specifically states that projections of the internal control evaluation to future periods is inappropriate.
Choice "d" is incorrect. The accountant does provide an opinion (and not a disclaimer) on the effective operation of internal control.

QUESTION 15
Processing data through the use of simulated files provides an auditor with information about the operating effectiveness of controls. One of the techniques involved in this approach makes use of:

A. Controlled reprocessing.
B. An integrated test facility.

C. Input validation.
D. Program code checking.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. An integrated test facility runs test transactions through the "live" system and posts to simulated (dummy) files to provide an auditor with information about the operating effectiveness of controls.
Choice "a" is incorrect. Controlled reprocessing of transactions is a less common term used for parallel processing where the auditor writes a program to "reprocess" some or all of the client's live data. It does not involve the use of simulated files.
Choice "c" is incorrect. Input validation is a general description of any test that ensures that the input was accurate. It does not involve the use of simulated files.
Choice "d" is incorrect. Program code checking is the review of the client's program source code by a qualified auditor/IT specialist. It does not involve the use of simulated files.

QUESTION 16
Which of the following statements concerning material weaknesses and significant deficiencies is correct with respect to an audit of a nonissuer?

A. An auditor need not identify and communicate material weaknesses separately from significant deficiencies.
B. All material weaknesses are significant deficiencies.
C. An auditor should report immediately material weaknesses and significant deficiencies discovered during an audit.
D. All significant deficiencies are material weaknesses.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. A material weakness in internal control is a significant deficiency that results in more than a remote likelihood that a material misstatement in the financial statements will not be prevented or detected.
Choice "a" is incorrect. The auditor is required to separately identify and communicate significant deficiencies and material weaknesses.
Choice "c" is incorrect. Significant deficiencies (including material weaknesses) are generally communicated to the appropriate parties after the audit is

complete. They may, at the auditor's discretion, be communicated during the audit, but there is no requirement for immediate communication.
Choice "d" is incorrect. A material weakness is a significant deficiency that results in more than a remote likelihood that a material misstatement in the financial statements will not be prevented or detected. Not all significant deficiencies will meet this description.

QUESTION 17
The management of Cain Company, a nonissuer, engaged Bell, CPA, to express an opinion on Cain's internal control. Bell's report described several material weaknesses and potential errors and irregularities that could occur. Subsequently, management included Bell's report in its annual report to the Board of Directors with a statement that the cost of correcting the weaknesses would exceed the benefits. Bell should:

A. Disclaim an opinion as to management's cost-benefit statement.
B. Advise the Board that Bell either agrees or disagrees with management's statement.
C. Advise management that Bell's report was restricted for use only by management.
D. Advise both management and the Board that Bell was withdrawing the opinion.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The auditor should disclaim an opinion as to management's cost-benefit statement (i.e., "We do not express an opinion or any other form of assurance on management's cost-benefit statement."). Choice "b" is incorrect. The CPA should disclaim an opinion regarding management's representation.
Choice "c" is incorrect. The CPA's report on internal control is not restricted as to use.
Choice "d" is incorrect. The CPA does not need to withdraw the opinion as long as a disclaimer on management's cost-benefit statement is presented.

QUESTION 18
An auditor's communication of internal control related matters noted in an audit usually should be addressed to:

A. Management and those charged with governance.
B. The director of internal auditing.
C. The chief financial officer.
D. The chief accounting officer.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. An auditor's communication of internal control related matters noted in an audit usually should be addressed to management and those charged with governance.
Choices "b", "c", and "d" are incorrect. The director of internal auditing, the chief financial officer, and the chief accounting officer all would have access to the letter; however, it would not be addressed to them since they do not have the same level of authority and responsibility to the shareholders as management and those charged with governance.

QUESTION 19
When reporting on conditions relating to an entity's internal control observed during an audit of the financial statements of a nonissuer, the auditor should include a:

A. Description of tests performed to search for material weaknesses.
B. Statement of positive assurance on internal control.
C. Paragraph describing the inherent limitations of internal control.
D. Restriction on the use of the report.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. When reporting on conditions relating to an entity's internal control observed during an audit of the financial statements, the auditor should include a restriction on the use of the report.
Choice "a" is incorrect. The auditor would not include a description of tests performed to search for material weaknesses since the auditor is not in fact obligated to search for them.
Choices "b" and "c" are incorrect. An auditor would make a statement of positive assurance on internal control and include a paragraph describing the inherent limitations of internal control in conjunction with an engagement to report on internal control. These comments would not be made when reporting on an entity's internal control in conjunction with an audit of the financial statements of a nonissuer.

QUESTION 20
An engagement to express an opinion on the internal control of a nonissuer 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.

Correct Answer: C
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "c" is correct. An engagement to express an opinion on internal control will generally be more extensive in scope than the assessment of control risk made during a financial statement audit of a nonissuer. This occurs because assessing control risk is the primary purpose of an engagement to express an opinion on internal control, whereas it is an incidental result of an audit of a nonissuer.
Choice "a" is incorrect. Since the results of the audit may be considered in performing the engagement to express an opinion on internal control, it is unlikely that the auditor would duplicate those procedures already applied.
Choice "b" is incorrect. It is unlikely that the reliability of the financial statements that have already been audited would be increased if an engagement to express an opinion on internal control is performed. Choice "d" is incorrect. An engagement to express an opinion on internal control is more extensive in scope than the control risk assessment performed during an audit of a nonissuer.

QUESTION 21
Which of the following statements is correct concerning significant deficiencies noted in an audit of a nonissuer?

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 should not be re-communicated each year if management has acknowledged its understanding of such deficiencies.

D. The auditor should separately identify those significant deficiencies that are considered to be material weaknesses.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. The auditor should separately identify those significant deficiencies that are considered to be material weaknesses.
Choice "a" is incorrect. Not all significant deficiencies are material weaknesses.
Choice "b" is incorrect. The auditor is not obligated to search for significant deficiencies. The auditor is obligated to communicate to the client any significant

deficiencies identified while auditing the financial statements. Choice "c" is incorrect. The auditor is obligated to re-communicate significant deficiencies each year, even if management has acknowledged its understanding of such deficiencies.

QUESTION 22
Which of the following statements concerning an auditor's communication of significant deficiencies identified during the audit of a nonissuer is correct?

A. The auditor should request a meeting with management one level above the source of the significant deficiencies to discuss suggestions for remedial action.
B. Any report issued on significant deficiencies should indicate that providing assurance on internal control was not the purpose of the audit.
C. Significant deficiencies discovered and communicated at an interim date should be reexamined with tests of controls before completing the engagement.
D. Suggestions concerning administration efficiencies and business strategies should not be communicated in the same report with significant deficiencies.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. Any report issued on significant deficiencies should indicate that providing assurance on internal control was not the purpose of the audit.
Choice "a" is incorrect. The auditor should communicate significant deficiencies to management and those charged with governance, but is not required to request a meeting with management one level above the source of the reportable conditions, to discuss suggestions for remedial action.
Choice "c" is incorrect. Significant deficiencies discovered and communicated at an interim date do not need to be reexamined with tests of controls before completing the engagement.
Choice "d" is incorrect. Suggestions concerning administration efficiencies and business strategies may be communicated in the same report with significant deficiencies (the significant deficiencies must be separately identified, however).

QUESTION 23
Which of the following representations should not be included in a report on internal control related matters noted in an audit of a nonissuer?

A. Significant deficiencies related to internal control design exist, but none is deemed to be a material weakness.
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.

Correct Answer: B
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "b" is correct. A report on internal control related matters noted in an audit should not state that there are no significant deficiencies in internal control, since this statement might erroneously imply that the auditor searched for such conditions.
Choice "a" is incorrect. The auditor is permitted to state that no material weaknesses were identified during the audit. Typically this occurs in reports submitted to governmental authorities.
Choice "c" is incorrect. The auditor may suggest that corrective follow-up action should be taken due to the relative significance of material weakness discovered.
Choice "d" is incorrect. The auditor's report may state that his or her consideration of internal control would not necessarily disclose all significant deficiencies that exist.

QUESTION 24
In obtaining an understanding of an entity's internal control in a financial statement audit, an auditor is not obligated to:

A. Determine whether the control activities have been implemented.
B. Perform procedures to understand the design of internal control.
C. Document the understanding of the entity's internal control components.
D. Search for significant deficiencies in the operation of internal control.

Correct Answer: D
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "d" is correct. When obtaining an understanding of an entity's internal control in a financial statement audit, an auditor is not obligated to search for significant deficiencies in the operation of internal control.
Choice "a" is incorrect. In order to determine the nature, timing and extent of tests to be performed, an auditor must determine whether the control activities have been implemented.
Choice "b" is incorrect. An auditor is required to perform procedures to confirm his/her understanding of the internal control systems' design, and to determine whether relevant controls have been implemented. Choice "c" is incorrect. An auditor is required to document his or her understanding of the entity's internal control components, even if he or she intends to use a substantive approach.

QUESTION 25
The GAO standards of reporting for governmental financial audits incorporate the AICPA standards of reporting and prescribe supplemental standards to satisfy

the unique needs of governmental audits. Which of the following is a supplemental reporting standard for governmental financial audits?

A. Auditors should report the scope of their testing of compliance with laws and regulations and of internal controls.
B. Material indications of illegal acts should be reported in a document distributed only to the entity's senior officials.
C. All changes in the audit program from the prior year should be reported to the entity's audit committee.
D. Any privileged or confidential information discovered should be reported to the organization that arranged for the audit.

Correct Answer: A
Section: Volume E
Explanation

Explanation/Reference:
Section: Volume E

Choice "a" is correct. The auditor's report on compliance and on internal control over financial recording (based on an audit) must include the scope of testing of compliance and internal control.
Choice "b" is incorrect. Material indications of illegal acts are not only reported to the members of the governing body of the audited entity and their senior staff officials but, in some circumstances, auditors should report illegal acts directly to external parties (such as the grantor agency).
Choice "c" is incorrect. Although GAO standards require that the auditor communicate information regarding the nature, timing and extent of planned testing to officials of the audited entity and to individuals contracting for the audit, reporting of all changes is not required. (For example, immaterial changes to the audit program need not be reported.)
Choice "d" is incorrect. Certain privileged or confidential information may be prohibited from general disclosure and should not be included in the audit report. The report should, however, disclose the nature of the information omitted and the requirement that makes an opinion necessary.