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Topic Break Down

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QUESTION NO: 1

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.

ANSWER: D

Explanation:

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 NO: 2

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.

ANSWER: A

Explanation:

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 NO: 3

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.

ANSWER: C

Explanation:

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 NO: 4

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.

ANSWER: C

Explanation:

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 NO: 5

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.

ANSWER: A

Explanation:

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 NO: 6

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.

ANSWER: A

Explanation:

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 NO: 7

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.

ANSWER: B

Explanation:

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 NO: 8

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.

ANSWER: A

Explanation:

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 NO: 9

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.

ANSWER: C

Explanation:

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 NO: 10

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.

ANSWER: B

Explanation:

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 NO: 11

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.

ANSWER: C

Explanation:

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 NO: 12

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.

ANSWER: C

Explanation:

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 NO: 13

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.

ANSWER: A

Explanation:

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 NO: 14

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.

ANSWER: A

Explanation:

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 NO: 15

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.

ANSWER: D

Explanation:

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 NO: 16

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.

ANSWER: D

Explanation:

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 NO: 17

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.

ANSWER: D

Explanation:

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 NO: 18

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.

ANSWER: A

Explanation:

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 NO: 19

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."

ANSWER: B

Explanation:

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 NO: 20

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.

ANSWER: A

Explanation:

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.