AUDITING & ATTESTATION

CPA2902US3-38

TABLE OF CONTENTS

ABOUT UPDATING SUPPLEMENT VERSION 38.3

This supplement is designed to bring the very latest information to candidates using our products in preparation for the CPA exam in the October-November 2009 and later exam windows. Candidates with the 38th edition textbook or the corresponding version 12 series software will find the information in updating supplement version 38.3 more than adequate for these exam windows.

When new information first becomes available, the examiners tend to test new or changed portions of concepts lightly. Coverage of information after that point may increase, if it is in a heavily tested area. Do not fall into the trap of attaching undue significance to new information merely because it is new.

Accounting and auditing pronouncements are eligible to be tested on the CPA exam in the testing window beginning six months after a pronouncement's *effective* date, unless early application is permitted. When early application is permitted, a new pronouncement may be tested in the window beginning 6 months after the *issue* date. In this case, *both* the previous and the new pronouncements can be tested until the previous pronouncement has been superseded.

Remember, with the information and techniques in our material, passing the exam is an attainable goal. ***Adhere to a reasonable study plan—and pass the first time!***

STUDY OPTIONS AVAILABLE TO CANDIDATES

As every candidate's needs are different, Bisk Education offers a variety of CPA Review formats and packages that are guaranteed* to help you pass the CPA exam on your next sitting. Options include: our Online CPA Review with structured Internet classes and our self-study CPA Review utilizing multimedia CD-ROM software, video lectures, audio lectures, and books.

**Purchase of software required. Call for complete details. (1-800-404-7231)*

OTHER SOURCES OF INFORMATION FOR CANDIDATES

Candidates choosing to use previous editions of our textbooks must accept responsibility for adequately updating their materials and should consider the strain this will add to the already time-consuming process of studying for the exam. Candidates with the 36th and earlier editions are strongly encouraged to purchase new materials. Please contact a customer service representative at 1-800-280-9718.

Candidates with the 37th edition of the textbook or corresponding version 11 series software will also need AUD Updating Supplement Version 37.3. AUD Updating Supplement Version 37.3 contains summaries of PCAOB AS 5; SSARS Nos. 15, 16, and 17; and SQCS 7. (This content is incorporated into the 38th edition.)

RECENT PRONOUNCEMENTS

SAS 115 (AU 325), ***Communicating Internal Control Related Matters Identified in an Audit*** **(issued 10/2008)**

This statement will be eligible to be tested beginning in the April-May 2009 exam window. ***Both*** **the previous and the new statement may be tested in the April-May, July-August, and October-November 2009 exam windows. Only the new statement will be testable starting with the January-February 2010 exam window.**

This statement is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.

This statement supersedes SAS 112 of the same title and was issued to incorporate the revisions of the definitions of the different kinds of deficiencies in internal control and align the related guidance for evaluating deficiencies in internal control with SSAE 15, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (also included in this updating supplement).

SAS 115 provides these revised definitions:

- A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a *reasonable possibility* (per the FASB's definition regarding accounting for contingencies) that a material misstatement of an entity's financial statements will not be prevented, or detected and corrected on a timely basis.
- A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a *material weakness,* yet important enough to merit attention by those charged with governance.

SAS 115 revises, reorders, and shortens the list of indicators of a material weakness to include:

- Identification of fraud, whether or not material, on the part of senior management
- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud
- Identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by an entity's internal control
- Ineffective oversight of an entity's financial reporting and internal control by those charged with governance

In the case where the nature of some matters directs their early communication, language has been added to strengthen the written communication requirements by stipulating that even if such significant deficiencies or material weaknesses are corrected (remediated) during the audit, they should still be included in the formal written communication required by this statement.

The guidance on the written communication has been revised as follows:

- A statement that indicates that the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses has been added to the list of elements that should be included in the written communication.
- The definition of the term *material weakness* should be included and, where relevant, the definition of the term *significant deficiency*, rather than the other way around.
- The illustrative written communication has been revised to reflect these changes.

SSAE 15 (AT 501), *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (issued 10/2008)

This statement will be eligible to be tested beginning in the April-May 2009 exam window. Only the new guidance will be testable starting with the April-May 2009 exam window.

This statement is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted. AT 501, the section of the authoritative guidance that covers SSAE 15, establishes requirements and provides guidance for the performance of an examination of a nonissuer's internal control over financial reporting (internal control) that is integrated with an audit of financial statements. (An auditor should **not** accept an engagement to *review* an entity's internal control or a written assertion thereon.) It supersedes the current section AT 501A, *Reporting on an Entity's Internal Control Over Financial Reporting.* The new statement was issued to align the definitions and related guidance for evaluating deficiencies in internal control with PCAOB AS 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements.*

1. **Applicability** AT 501 does **not** provide guidance for the following engagements:

a. As covered under AT 101, *Attest Engagements*:

(1) Examining the suitability of design of an entity's internal control

(2) Examining controls over the effectiveness and efficiency of operations

b. Performance of agreed-upon procedures on controls covered under AT 201, *Agreed-Upon Procedures Engagements*

c. Examining controls over compliance with laws and regulations covered under AT 601, *Compliance Attestation*

d. Reporting on controls at a service organization covered under AU 334, *Service Organizations*

2. **Objective** The auditor's objective is to form an opinion on the effectiveness of an entity's internal control as of a point in time and taken as a whole. To express an opinion as of a point in time, the auditor should obtain evidence that internal control has operated effectively for a sufficient period of time which may be less than the period covered by the company's financial statements. To express an opinion on internal control taken as a whole, the auditor should obtain evidence about the effectiveness of selected controls over *all* relevant assertions. This involves testing the design and operating effectiveness of controls that in most cases would **not** be required if *only* expressing an opinion on the financial statements.

a. **Material Weaknesses** If one or more material weaknesses exist, an entity's internal control *cannot* be considered effective, thus, the auditor must obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assertion. There may be a material weakness in internal control even when financial statements are **not** materially misstated. An auditor is **not** required to search for deficiencies that are less severe than a material weakness.

b. **Standards and Criteria** An auditor should comply with the general, fieldwork, and reporting attestation standards required for all attestation engagements and the specific requirements covered in this statement. An auditor should use the same suitable and available criteria to perform an examination as management uses for its evaluation.

3. **Definitions**

a. **Control Objective** A control objective is the aim or purpose of specified controls. Control objectives ordinarily address the risks that the controls are intended to mitigate. In the context of internal control, a control objective generally relates to a relevant assertion for a significant account or disclosure and addresses the risk that the controls in a specific area will not provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented, or detected and corrected on a timely basis.

b. **Deficiency** A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

(1) A deficiency in *design* exists when

(a) A control necessary to meet the control objective is missing or

(b) An existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

(2) A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

c. **Detective Control** A detective control is a control that has the objective of detecting and correcting errors or fraud that have already occurred that could result in a misstatement of the financial statements.

d. **Financial Statements and Related Disclosures** Financial statements and related disclosures are an entity's financial statements and notes to the financial statements as presented in accordance with the applicable financial reporting framework. References to financial statements and related disclosures do **not** extend to the preparation of other financial information presented outside an entity's basic financial statements and notes.

e. **Internal Control Over Financial Reporting** Internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements for external purposes in accordance with the applicable financial reporting framework and includes those policies and procedures that

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of an entity

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the applicable financial reporting framework, and that receipts and expenditures of an entity are being made only in accordance with authorizations of management and those charged with governance

(3) Provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of an entity's assets that could have a material effect on the financial statements

Note: Internal control has *inherent limitations.* Internal control is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented, or detected and corrected on a timely basis by internal control. However, these inherent limitations are known aspects of the financial reporting process.

f. **Management's Assertion** Management's assertion is management's conclusion about the effectiveness of an entity's internal control that is included in management's report on internal control.

g. **Material Weakness** A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a *reasonable possibility* (per the FASB's definition regarding accounting for contingencies) that a material misstatement of an entity's financial statements will not be prevented, or detected and corrected on a timely basis.

h. **Preventive Control** A preventive control is a control that has the objective of preventing errors or fraud that could result in a misstatement of the financial statements.

i. **Relevant Assertion** A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of controls.

j. **Significant Account or Disclosure** A significant account or disclosure is an account balance or disclosure that has a reasonable possibility that it could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account balance or disclosure is a significant account or disclosure is made without regard to the effect of controls.

k. **Significant Deficiency** A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

4. Required Conditions for Performance of Examination

a. Management accepts responsibility for the effectiveness of the entity's internal control.

b. Management evaluates the effectiveness of the entity's internal control using suitable and available criteria.

c. Management supports its assertion about the effectiveness of the entity's internal control with sufficient appropriate evidence. This includes documentation of the controls and their objectives and evidence of monitoring activities.

d. Management provides its assertion about the effectiveness of the entity's internal control in a report that accompanies the auditor's report.

5. Integrating the Examination With the Financial Statement Audit

a. **Significant Accounts and Disclosures and Their Relevant Assertions** The significant accounts and disclosures and their relevant assertions and the risk factors used to identify them are the same in an examination of internal control (examination) as in an audit of financial statements (audit).

b. **Tests of Controls** The tests of controls should be designed to achieve the objectives of both engagements simultaneously, i.e., to obtain sufficient appropriate evidence to support the auditor's opinion on internal control as well as the auditor's risk assessment for purposes of the audit. As previously mentioned, for the purposes of the audit, the auditor is **not** required to test the controls of *all* relevant assertions as is required in the examination. Consideration of the results of the additional tests of controls performed for the purposes of the examination may affect the auditor's decisions about the nature, timing, and extent of substantive procedures and further tests of controls for the purposes of the audit. Obviously, this would be particularly true if deficiencies were identified in the examination.

c. **Substantive Procedures** Likewise, the results of substantive procedures performed for purposes of the audit should be evaluated to determine their effect on the auditor's risk assessments regarding the testing necessary to form a conclusion about the effectiveness of a control in the examination. Results of substantive tests of particular interest include those related to fraud, illegal acts, related party transactions, and those that detect misstatements or indicate management bias in making accounting estimates or selecting accounting principles.

d. **Period End Reporting Process** As part of the examination, the auditor should evaluate the procedures that make up the period end reporting process because of its importance to financial reporting and the integrated approach.

e. **Risk Assessment and Materiality** The same materiality should be used for planning and performing both engagements and the same risk assessment process supports both.

f. **Fraud Risk Assessment** The results of the fraud risk assessment for the purposes the audit should be incorporated into the examination. The auditor should consider whether the identified risks due to fraud and inappropriate management override of other controls are sufficiently addressed by the internal control system.

g. ***As of* Date or Period Covered** The date specified in management's assertion (the *as of* date of the examination) should correspond to the balance sheet date of the period covered by the financial statements. If management chooses an *as of* date for the examination that is different than the end of the entity's fiscal year, the examination and the audit should still be integrated. If the auditor is engaged to examine the effectiveness of internal control for a period of time (rather than an *as of* date), the examination should be integrated with an audit that covers the same period.

h. **Auditor's Report Date** Because the examination is integrated with the audit, the dates of the reports should be the same.

6. **Planning**

a. **Role of Risk Assessment** Risk assessment underlies all phases of the examination process. Obviously, the auditor should focus on areas with the highest risk. It is **not** necessary to test controls that, even if deficient, do not present a reasonable possibility of a material misstatement to the financial statements. The auditor should bear in mind that an entity's internal control is *less* likely to prevent or detect and correct a misstatement caused by fraud than one due to error. Additionally, the size and complexity of an organization affects the auditor's risk assessment, allowing scaling of the examination for smaller and/or less complex entities.

b. **Using the Work of Others** In an examination, the auditor may use the work of others within the entity (in addition to internal auditors) and third parties. The auditor should consider their objectivity and competence in the same manner as that of internal auditors for purposes of the audit. As the risk associated with a control increases, so does the need for the auditor to perform the work.

c. **Control Environment** The auditor should evaluate the control environment because of its importance to effective internal control.

7. **Selection of Controls to Test** The auditor should use a top-down approach, starting with the financial statements and then focusing on the entity-level controls; working down to the identification of the significant accounts, disclosures and their relevant assertions that present a reasonable possibility of material misstatement of the financial statements. The auditor can then select the controls that sufficiently address the assessed risk of material misstatement to each relevant assertion.

8. **Testing Controls** As the risk associated with a control increases, the evidence the auditor should obtain also increases. As previously mentioned, the auditor is expressing an opinion on internal control *taken as whole.* The risk-based approach allows the auditor to vary the amount of evidence obtained for individual controls.

In order of *least* evidence produced to most, these are the tests an auditor might perform: inquiry, observation, inspection of documentation, recalculation, and reperformance of a control. Inquiry alone does **not** provide sufficient appropriate evidence to support a conclusion about the effectiveness of a control. The quality of evidence is enhanced by testing controls over a longer period of time and closer to the *as of* date of the examination.

a. Design Effectiveness Walk-throughs (following a transaction from origination through the entity's processes until it is reflected in the financial statements, using the same documents and information technology that entity personnel use) are usually sufficient to evaluate design effectiveness.

b. Operating Effectiveness Procedures include a mix of inquiry, observation, inspection of documentation, recalculation, and reperformance of the control. Because only reasonable rather than absolute assurance is provided by effective internal control, an individual control does **not** have to operate without any deviation to be considered effective.

9. Evaluation of Identified Deficiencies

a. Severity The auditor should evaluate the severity of each deficiency to determine whether it, individually or in combination, is a material weakness. The severity does **not** depend on whether a misstatement actually occurred. A compensating control can limit the severity of a deficiency and prevent it from being a material weakness. Severity depends on

(1) The magnitude of the potential misstatement

(2) Whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct a misstatement

b. Indicators of a Material Weakness

(1) Identification of fraud, whether or not material, on the part of senior management

(2) Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud

(3) Identification by the auditor of a material misstatement of financial statements under audit in circumstances that indicate that the misstatement would not have been detected and corrected by the entity's internal control

(4) Ineffective oversight of the entity's financial reporting and internal control by those charged with governance

c. Prudent Official Standard If a determination is made that a deficiency is **not** a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion.

10. Evaluation of Management's Report The auditor should determine if management's report appropriately includes the following:

a. A statement regarding management's responsibility for internal control

b. A description of the subject matter of the examination

c. An identification of the criteria against which internal control is measured

d. Management's assertion about the effectiveness of internal control

e. A description of the material weaknesses, if any

f. The date as of which management's assertion is made

11. Management's Written Representations The auditor should obtain representations from management:

a. Acknowledging management's responsibility for establishing and maintaining effective internal control

b. Stating that management has performed an evaluation of the effectiveness of the entity's internal control and specifying the control criteria

c. Stating that management did not use the auditor's procedures performed during the integrated audit as part of the basis for management's assertion

d. Stating management's assertion about the effectiveness of the entity's internal control based on the control criteria as of a specified date

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control

f. Describing any fraud resulting in a material misstatement to the entity's financial statements and any other fraud that does not result in a material misstatement to the entity's financial statements, but involves senior management or management or other employees who have a significant role in the entity's internal control

g. Stating whether the significant deficiencies and material weaknesses identified and communicated to management and those charged with governance during previous engagements have been resolved and specifically identifying any that have not

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control or other factors that might significantly affect internal control, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses

12. Communications

a. Significant deficiencies and material weaknesses should be communicated, in writing by the auditor's report release date, to the entity's management and those charged with governance, including those previously communicated, but **not** remediated. In the case where the nature of some matters directs their early communication, even if such significant deficiencies or material weaknesses are remediated during the audit, they should still be included in this formal written communication. (At the time of their initial early communication, they are not required to be in writing.)

b. If the auditor concludes that the oversight of the entity's financial reporting and internal control by the entity's audit committee (or similar subgroup) is inadequate, the auditor should communicate this, in writing by the auditor's report release date, to the board of directors (or similar governing body if one exists).

c. The auditor should also communicate to management, in writing, all identified deficiencies which are not significant deficiencies or material weaknesses, no later than 60 days following the report release date and inform those charged with governance when this communication has been made. As previously mentioned, the auditor is **not** required to search for deficiencies that are less severe than a material weakness, thus this communication would only include deficiencies of which the auditor is *aware.*

d. If one or more material weaknesses are identified which are **not** disclosed or identified in management's report, the auditor should communicate this, in writing, to those charged with governance.

e. If the auditor cannot express an opinion because there has been a limitation on the scope of the examination, the auditor should communicate, in writing, to management and those charged with governance that the examination cannot be satisfactorily completed.

f. If the auditor concludes that additional information contained in management's report contains a material misstatement of fact that management refuses to revise, the auditor should notify management and those charged with governance, in writing, of the auditor's views.

13. Reporting on Internal Control

a. The auditor's report on an examination should include these elements:

(1) A title that includes the word *independent*

(2) A statement that management is responsible for maintaining effective internal control and for evaluating the effectiveness of internal control

(3) An identification of management's assertion on internal control that accompanies the auditor's report, including a reference to management's report

(4) A statement that the auditor's responsibility is to express an opinion on the entity's internal control (or on management's assertion) based on the auditor's examination

(5) A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants

(6) A statement that such standards require that the auditor plan and perform the examination to obtain reasonable assurance about whether effective internal control was maintained in all material respects

Editor note: An examination provides the same level of assurance as an audit.

(7) A statement that an examination includes obtaining an understanding of internal control, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considers necessary in the circumstances

(8) A statement that the auditor believes the examination provides a reasonable basis for the auditor's opinion

(9) A definition of internal control (the auditor should use the same description of the entity's internal control as management uses in its report)

(10) A paragraph stating that, because of inherent limitations, internal control may not prevent, or detect and correct misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate

(11) The auditor's opinion on whether the entity maintained, in all material respects, effective internal control as of the specified date, based on the control criteria; **or,** the auditor's opinion on whether *management's assertion* about the effectiveness of the entity's internal control as of the specified date is fairly stated, in all material respects, based on the control criteria

(12) The manual or printed signature of the auditor's firm

(13) The date of the report which should be no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the auditor's opinion.

b. The auditor should **not** issue a report stating that **no** deficiencies were identified.

c. The auditor should **not** issue a report indicating that **no** material weaknesses were identified.

d. The auditor may issue a combined report or separate reports on the entity's financial statements and on internal control.

e. **Report Modifications**

(1) **Defects in Management's Report** If the elements of management's report are incomplete or improperly presented and management refuses to revise their report, the auditor should add an explanatory paragraph to the auditor's report describing the reasons for this determination.

(2) **Opinion Based, in Part, on the Report of Another Auditor** When the auditor has examined the internal control of one or more components of an entity, the auditor should determine whether to serve as the principal auditor and use the work and report of another auditor as the basis, in part, for the her/his own opinion. The standard states that AU 543, *Part of Audit Performed by Other Independent Auditors,* is applicable to this determination by the auditor. (See page 28-11 of the 38th edition of the textbook.) When the auditor decides to make reference to the report of another auditor, the scope and opinion paragraphs of the principal auditor's report should be modified accordingly.

(3) **Additional Information in Management's Report** If management's report includes additional information (beyond the elements previously described) that appear to be part of management's report, the auditor should add an explanatory paragraph as the last paragraph in the auditor's report that disclaims an opinion on the additional information. If the auditor believes the additional information contains a material misstatement of fact, the auditor should refer to the guidance in AT 101 on the same issue with information contained in a client-prepared document containing a practitioner's attest report. (See page 31-31 of the 38th edition of the textbook.) In some instances, the auditor may also need to apply the guidance in AU 317, *Illegal Acts by Clients.* (See the section on this topic in Chapter 22 of the 38th edition of the textbook.)

(4) **Subsequent Event** If the auditor obtains knowledge about conditions that did **not** exist at the date specified in management's assertion, but arose subsequent to that date and before the release of the auditor's report that had a material effect on the entity's internal control, the auditor should include an explanatory paragraph in the auditor's report that describes the event and its effects or refers the reader to the same information in management's report.

f. **Adverse Opinion** If there is more than one material weakness, the auditor should express an adverse opinion. (This also applies when the auditor discovers a material weakness subsequent to the *as of* date of the examination, but before the date of the auditor's report that existed as of the date in management's assertion and whose effect on internal control can be determined. If this type of subsequently discovered material weakness's effect cannot be determined, the auditor should disclaim an opinion.) Under these circumstances, the auditor is prohibited from expressing an opinion on management's assertion and should report *directly* on the effectiveness of internal control. (See the eleventh element of the auditor's report.) The auditor should determine the effect of an adverse opinion on the auditor's opinion on the financial statements and disclose whether the auditor's opinion on the financial statements was affected by the material weakness. This adverse report on internal control should include

(1) A definition of material weakness

(2) A statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in management's report; the auditor's report does **not** need to include a description of the material weaknesses *as long as* each material weakness is included and fairly presented in all material respects in management's report

(3) If management's report does **not** include a fair presentation of all material weaknesses, the auditor's report should include

(a) A statement that one or more material weaknesses have been identified but not included in management's report

(b) A description of all such material weaknesses which contains specific information about the nature of each, and its actual and potential effect on the presentation of the entity's financial statements

(c) In the case where one or more material weaknesses have been included in management's report, but not fairly presented, the auditor's report should state this conclusion and include the information needed for a fair presentation

g. Disclaimer of Opinion or Withdrawal From an Engagement

(1) Management's refusal to furnish an assertion about the effectiveness of the entity's internal control in a report that accompanies the auditor's report should cause the auditor to withdraw from the engagement. If a law or regulation prohibits the auditor's withdrawal, the auditor should disclaim an opinion on internal control.

(2) If there are restrictions on the scope of an engagement, for example, if management refuses to provide written representations, the auditor should either withdraw from the engagement or disclaim an opinion. The auditor may issue the disclaimer of opinion as soon as the auditor concludes that the scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. No additional work is required.

(3) The auditor should disclaim an opinion when the auditor discovers a material weakness subsequent to the *as of* date of the examination, but before the date of the auditor's report that existed as of the date in management's assertion and whose effect on internal control can**not** be determined. (If its effect can be determined, the auditor should issue an adverse opinion.)

(4) A disclaimer of opinion should include the following:

(a) A statement that the auditor does not express an opinion on the effectiveness of internal control

(b) In a separate paragraph or paragraphs, an explanation that includes the substantive reasons for the disclaimer

(c) If the limited procedures performed allowed the auditor to conclude that one or more material weaknesses exist, the auditor's report should also include the definition of a material weakness and a description of any material weakness identified that includes specific information about the nature of any material weakness and its actual and potential effect on the entity's financial statements. The auditor should also determine the effect the material weakness has on the auditor's opinion of the financial statements and should disclose whether the auditor's opinion was affected by the material weaknesses.

(5) A disclaimer of opinion should **not** include the identification of the procedures that were performed **nor** include statements describing the characteristics of an examination.

PCAOB AS 6, Evaluating Consistency of Financial Statements and Conforming Amendments (issued 9/2008)

This statement will be eligible to be tested beginning in the July-August 2009 exam window. Only the new guidance will be testable starting with the July-August exam 2009 window.

This statement is effective November 15, 2008. It supersedes the PCAOB's adopted interim standards AU 420, *Consistency of Application of Generally Accepted Accounting Principles*, and AU 9420, *Consistency of Application of Generally Accepted Accounting Principles: Auditing Interpretations of Section 420.*

Editor note: All references to AU standards and previous guidance are the interim auditing standards adopted by the PCAOB.

Overview

PCAOB AS 6 updates the auditor's responsibilities to evaluate and report on the consistency of financial statements of issuers. The amendment to AU 411 moves the GAAP hierarchy from the *auditing* standards in coordination with its incorporation into the *accounting* standards by the FASB.

Consistency and the Auditor's Report

To identify consistency issues that might affect the auditor's report, the new standard focuses on the evaluation of whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles or by adjustments to correct a misstatement in previously issued financial statements for the relevant periods. (Unlike the previous guidance, the new standard does not include descriptions of accounting changes that do not require recognition in the auditor's report.)

The new standard aligns the definitions of accounting changes versus misstatements (errors) and other related matters with the FASB's current guidance.

The standard requires the auditor's report to recognize a company's correction of a material misstatement regardless of whether it involves the application of an accounting principle.

The standard requires a clear indication in the explanatory paragraph added to the auditor's standard report as to whether an adjustment to prior period financial statements results from a change in accounting principle or the correction of a misstatement. (See the example paragraphs that are included in the following sections.)

Editor note: The 2^{nd} standard of reporting states that the auditor must identify in the auditor's report those circumstances in which such *principles* [GAAP] have not been consistently observed in the current period in relation to the preceding period. The consistency evaluation required by this new standard is broader than that described by the second standard of reporting because it includes errors not involving an accounting principle.

Change in Accounting Principle

When there is a change in accounting principle, this evaluation involves the determination of whether:

- The accounting principle is GAAP
- The method of its application conforms with GAAP
- Disclosures are adequate
- The entity has appropriately justified the change as preferable

If an accounting change meets the above criteria and has a material effect on the financial statements, the auditor should add an explanatory paragraph *following* the opinion paragraph to the auditor's standard report. (Editor note: If these criteria are not met, the auditor would consider it a departure from GAAP and issue a qualified or adverse opinion.) This explanatory paragraph should include identification of the nature of the change and a reference to the note disclosure describing the change.

The following is an example of an explanatory paragraph when a change results from the adoption of a new accounting pronouncement:

> As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

The following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:

> As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].

The new standard notes that the requirement for an explanatory paragraph following the opinion paragraph is also applicable when a company accounts for an investment by the equity method and the investee company makes a change in accounting principle that is material to the investing company's financial statements.

The new standard does not change the scope (reporting periods) of the required evaluation of consistency. Nor does it change the guidance on the treatment of a change in accounting estimate or a change in reporting entity.

Correction of a Material Misstatement in Previously Issued Financial Statements

The correction of a material misstatement in previously issued financial statements should also be recognized in the auditor's standard report through the addition of an explanatory paragraph *following* the opinion paragraph. This aligns the auditor's reporting responsibilities with the accounting standards, which require disclosure of all restatements, by requiring an explanatory paragraph when the company has restated the financial statements. The previous guidance did not require recognition in the auditor's report of the correction of the misstatement unless it involved an accounting principle (a change from one that was not GAAP to one that was GAAP) or its application.

The explanatory paragraph should include a statement that the previously issued financial statements have been restated for the correction of misstatement in the respective period and a reference to the company's note disclosure of the correction of the misstatement. An example is:

> As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

Change in Classification

The standard expands the guidance on a change in classification. Changes in classification in previously issued financial statements do not require recognition in the auditor's report unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in classification and the related disclosure to determine if this is the case. For example, reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, if those items were incorrectly classified, would be the correction of a misstatement.

Conforming Amendments

GAAP Hierarchy

The amendment to the PCAOB's adopted interim standard AU 411 removes the hierarchy for accounting principles generally accepted in the U.S. from their auditing standards because both the FASB and the PCAOB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. One of the reasons cited was that as the GAAP hierarchy identifies the sources of accounting principles and the framework for selecting principles, these requirements are more appropriately located in the accounting standards. Further, the GAAP hierarchy's requirements should be directed to the entity rather than the auditor.

Other Conforming Amendments

With the exception of the amendment of AU 411 (see preceding paragraph), the PCAOB has characterized these amendments as generally technical or conforming in nature, such as updating references to interim standards to the new standard's paragraph numbers or definitions.

SAS 116 (AU 722), Interim Financial Information and SSARS 18, *Applicability of Statements on Standards for Accounting and Review Services* (AR 100, *Compilation and Review of Financial Statements*); both issued 2/2009

These statements will be eligible to be tested beginning in the October-November 2009 exam window. Both the previous and the new guidance may be tested in the October-November 2009 exam window. Only the new guidance will be testable starting with the January-February 2010 exam window.

SAS 116 Effective Date SAS 116 is effective for reviews of interim financial information of nonissuers for interim periods beginning after December 15, 2009. Early application is permitted.

SSARS 18 Effective Date SSARS 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009. Early application is permitted.

Overview

These two new standards were issued at the same time to clarify when the Statements on Auditing Standards are applicable for reviews of interim financial information of nonissuers versus when the guidance in the Statements on Standards for Accounting and Review Services should be followed.

The issuance of SAS 116 is an acknowledgement of the difference between a review performed by an accountant with an audit base of knowledge versus that performed by an accountant who is not the entity's auditor. When the conditions required by AU 722 (as amended by SAS 116) are met, i.e., when the review should be in accordance with the auditing standards, generally, the review engagement is intended to provide a periodic update to the year-end reporting and is considered an extension of the annual audit. Accordingly, if these conditions are **not** met, reviews of interim financial information of nonissuers should be performed in accordance with the SSARS. (SSARS 18 simply amends AR 100 with a note that the SSARS do not apply to reviews of interim financial information when the provisions of AU 722 apply.)

SAS 116 also revised AU 722 to better accommodate reviews of interim financial information of nonissuers performed for a broader range of purposes. And it removes guidance for reviews of interim financial information for issuers—guidance for issuers resides in the PCAOB's adopted transitional auditing standards.

Applicability AU 722 is applicable to the review of interim financial information by an accountant if:

- The entity's latest annual financial statements have been audited by the accountant or a predecessor;
- The accountant has been engaged to audit the entity's current year financial statements, or the accountant audited the entity's latest annual financial statements and expects to be engaged to audit the current year financial statements;
- The client prepares its interim financial information in accordance with the same *financial reporting framework* as that used to prepare the annual financial statements.

Financial reporting framework is defined as a set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements. This would include, for example, financial statements prepared in accordance with GAAP, IFRS, or OCBOA. Generally, AU 722 has been amended throughout by substituting the term *applicable financial reporting framework* for the term *generally accepted accounting principles.*

Definition of *Interim Financial Information* SAS 116 amends the definition of the term *interim financial information* to include condensed financial statements. The previous guidance allowed for a *summarized* format per GAAP and regulatory requirements in the context of its discussion of applicability, but a condensed format was not part of the definition. The definition now includes a statement that interim financial information may be condensed or in the form of a complete set of financial statements.

Conditions for Condensed Interim Financial Information The new guidance includes criteria for condensed information. An accountant may conduct, in accordance with AU 722, a review of condensed interim financial information if *all* of the following conditions are met:

- The condensed interim financial information purports to conform with an appropriate financial reporting framework, which includes appropriate form and content of interim financial statements.
- The condensed interim financial information includes a note that the financial information does not represent complete financial statements and should be read in conjunction with the entity's latest annual audited financial statements.
- The condensed interim financial information accompanies the entity's latest audited annual financial statements or such audited annual financial statements are made readily available by the entity. The financial statements are deemed to be readily available if a third party user can obtain the financial statements without any further action by the entity. For example, financial statements on an entity's Web

site may be considered readily available, but being available upon request is not considered readily available.

Other changes to AU 722 include:

- **When Review Report Must Accompany Interim Financial Information** The previous guidance referenced the SEC's requirement that the accountant's review report be filed with interim financial information if the entity stated in its filing that it has been reviewed by an independent public accountant. The guidance now omits any reference to the SEC on this matter and replaces the SEC's requirement with a similar one of its own.

  The new guidance states that although this section of guidance generally does not require an accountant to issue a written report on a review of interim financial information, an accountant's review report should accompany the interim financial information if, in any document containing it, the entity states that it has been reviewed by an independent public accountant or makes other reference to the accountant's association.

  The new guidance leaves it up to the accountant's judgment to include a written report in other situations where there is a risk a user may inappropriately assume a higher level of assurance than that obtained if the accountant's association with the interim financial information is known to the user.

- **Establishing Understanding With Client** The guidance now states that the accountant should document the understanding through a written communication with the client. Previously it was required to be documented, but the written communication with the client was described only as preferable.

  The understanding should include a description of the expected form of the accountant's communication upon completion of the engagement, i.e., whether it is to be a written or oral report.

  Also, acceptance of the engagement is now specifically predicated on the accountant's assessment of management's ability to make the acknowledgment that they have the responsibility to establish and maintain controls that are sufficient to provide a reasonable basis for the preparation of reliable interim financial information in accordance with the applicable financial framework. This has also been added to the list of written management representations that the accountant should obtain.

  The guidance has been expanded to include the following in the list of items that generally would be included in the understanding with the client:

  - **When Review Report Must Accompany Interim Financial Information** A statement that if the entity states in any document that contains the interim information that it has been reviewed by the accountant or makes other reference to the accountant's association, that the accountant's review report will be included in the document.

  - **Additional Statements on Limitations of the Engagement**

    - A review does not provide a basis for expressing an opinion about whether the financial information is presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

    - A review does not provide assurance that the accountant will become aware of all significant matters that would be identified in an audit.

- **Communications to Those Charged With Governance** If the client represents in a document containing the reviewed interim financial information that it has been reviewed by the accountant, but refuses to include the accountant's review report, the new guidance requires the accountant to communicate the client's noncompliance to those charged with governance.

PCAOB AS 7, Engagement Quality Review; issue date pending approval by the Securities and Exchange Commission (SEC)

In July 2009, the Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard (AS) 7, *Engagement Quality Review* (EQR). AS 7, **subject to SEC approval**, will become effective for EQRs of audits and interim reviews for fiscal years beginning on or after December 15, 2009, and will supersede the PCAOB's existing concurring partner review requirement. When this updating supplement was released, AS 7 had not been approved by the SEC. Visit the standards section of the PCAOB's Web site (www.pcaob.org) to check its status and confirm its effective date.

If approved by the SEC with its current effective date and without early adoption permitted, AS 7 is eligible to be tested beginning with the July-August 2010 exam window.

A. Overview

1. **Applicability** An EQR and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted in accordance with the standards of the PCAOB.

2. **Objective** The objective of the reviewer is to perform an evaluation of the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report, if a report is to be issued, in order to determine whether to provide concurring approval of issuance.

B. Qualifications of an Engagement Quality Reviewer

1. The reviewer must be an associated person of a registered public accounting firm. A reviewer from the firm that issues the engagement report (or communicates an engagement conclusion, if no report is issued) is required to be a partner or another individual in an equivalent position

   Editor note: The term *engagement partner* has the same meaning as *auditor with final responsibility for the audit* as used in AU 311, *Planning and Supervision*.

   The reviewer may also be an individual from outside the firm.

   Editor note: When this is the case, the firm will likely need to made additional inquiries to ascertain whether the individual is qualified.

2. A reviewer must have competence, independence, integrity, and objectivity.

   a. **Competence** The reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.

      Editor note: The reviewer is **not** required to possess other competencies such as those related to communication or management skills that the engagement partner may have. Nor is the reviewer's knowledge and competence required to match that of the engagement partner—AS 7 sets a minimum requirement. The appropriate level of knowledge and competence should be dictated by the circumstances of the particular engagement.

   b. **Independence, Integrity & Objectivity** The reviewer must be independent of the client, perform the EQR with integrity, and maintain objectivity in performing the review. If the reviewer uses assistants, they must also meet these standards.

      Maintaining Objectivity It is important that the engagement partner remains responsible for the engagement despite the activities of the reviewer.

      The reviewer and any assistants

      (1) Should **not** make decisions on behalf of the engagement team

(2) Should **not** assume any of the responsibilities of the engagement team

(3) **Two-Year Cooling-Off Period** An engagement partner is prohibited from serving as a reviewer for at least 2 years following the last year as an engagement partner for the audit of the same client. Certain smaller firms that qualify for the exemption from the SEC partner rotation requirements do not have to comply with this AS 7 requirement.

C. Procedures

1. The reviewer should hold discussions with the engagement partner and team and review the engagement documentation to the extent needed to:

a. Evaluate the significant judgments that relate to engagement planning, including

For both an audit and review of interim financial information:

(1) The consideration of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process

(2) The consideration of the company's business, recent significant activities, and related financial reporting issues and risks

For an audit only:

(3) The judgments made about materiality and the effect of those judgments on the engagement strategy

For a review of interim financial Information only:

(3) The nature of identified risks of material misstatement due to fraud

Editor note: AS 7 requires the reviewer to evaluate the engagement team's consideration of risks that have already been identified, for example, during the preceding year's audit.

For an audit only:

b. Evaluate the engagement team's assessment of, and audit responses to

(1) Significant risks identified by the engagement team, including fraud risks

(2) Other significant risks identified by the reviewer through performance of the procedures required by AS 7

Editor note: A *significant risk* is a risk of material misstatement that is important enough to require special audit consideration.

c. Evaluate the significant judgments made about the

For both an audit and review of interim financial information:

(1) Materiality and disposition of corrected and uncorrected identified misstatements

For an audit only:

(2) Severity and disposition of identified control deficiencies

For a review of interim financial Information only:

(2) Any material modifications that should be made to the disclosures about changes in internal control over financial reporting

For both an audit and review of interim financial information:

d. Review the engagement team's evaluation of the firm's independence in relation to the engagement.

For both an audit and review of interim financial information:

e. Review the engagement completion document and confirm with the engagement partner that there are no significant unresolved matters.

Editor note: PCAOB AS 3, *Audit Documentation*, requires the auditor to identify all significant findings or issues in an *engagement completion document*.

For an audit only:

f. Review the financial statements, management's report on internal control, and the related engagement report.

g. Read other information in documents containing the financial statements to be filed with the SEC and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the reviewer is aware.

For a review of interim financial Information only:

f. Review the interim financial information for all periods presented and for the immediately preceding interim period, management's disclosure for the period under review, if any, about changes in internal control over financial reporting, and the related engagement report, if a report is to be issued.

g. Read other information in documents containing interim financial information to be filed with the SEC and evaluate whether the engagement team has taken appropriate action with respect to material inconsistencies with the interim financial information or material misstatements of fact of which the reviewer is aware.

For both an audit and review of interim financial information:

h. Based on the procedures required by AS 7, evaluate whether appropriate consultations have taken place on difficult or contentious matters. Review the documentation, including conclusions, of such consultations.

i. Based on the procedures required by AS 7, evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.

2. **Evaluation of Engagement Documentation** The reviewer should evaluate whether the engagement documentation reviewed when performing the procedures described above

For an audit only:

a. Indicates that the engagement team responded appropriately to significant risks

For both an audit and review of interim financial information:

b. Supports the conclusions reached by the engagement team with respect to the matters reviewed

For both an audit and review of interim financial information:

3. Concurring Approval of Issuance The reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by AS 7, the reviewer is not aware of a significant engagement deficiency.

The firm may grant permission to the client to use the engagement report (or communicate an engagement conclusion to its client, if no report is issued in a review of interim financial information) only after the reviewer provides concurring approval of issuance.

A *significant engagement deficiency exists* when

For an audit only:

a. The engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB.

For a review of interim financial information only:

a. The engagement team failed to perform interim review procedures necessary in the circumstances of the engagement.

For both an audit and review of interim financial information:

b. The engagement team reached an inappropriate overall conclusion on the subject matter of the engagement.

c. The engagement report is not appropriate n the circumstances.

d. The firm is not independent of its client.

D. Documentation of Engagement Quality Review

Documentation of an EQR should contain sufficient information to enable an *****experienced auditor, having no previous connection with the engagement, to understand the procedures performed during the review to comply with the provisions of AS 7, including information that identifies:

1. The reviewer, and others who assisted the reviewer

2. The documents reviewed by the reviewer, and others who assisted the reviewer

3. The date the reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval

Documentation of an EQR should be included in the engagement documentation. The requirements related to retention of and subsequent changes to audit documentation in PCAOB AS 3, *Audit Documentation*, apply with respect to the documentation of the EQR.

*****Editor note: An experienced auditor, per PCAOB AS 3, has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

ERRATA

The following items are in the textbook only, unless otherwise noted. If you find other items that you believe are ambiguous or in error, please contact the Bisk Education editors (editor@cpaexam.com) with details.

Chapter 26: Page 26-20, the explanation for Example (not Exhibit) 9 should state that the tolerable rate has been determined to be 3% instead of “Remember that the tolerable rate is 3%.”

Chapter 29: Please disregard multiple-choice question nos. 19, 20, 22, 26, and 28, starting on page 29-33 and nos. 44, 47, and 48 starting on page 29-37, all of which concern an audit of internal control over financial reporting (ICFR). PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (which superseded AS 2) shifted the focus of an audit of ICFR from a review of management’s evaluation process of ICFR to a review of the effectiveness of a company’s ICFR and it contains less detailed guidance in many areas. Therefore it is very unlikely that the issues as presented in these multiple-choice questions will be tested.

Multiple-choice question 42 on page 29-37 and its answer explanation on page 29-45 should be replaced with the following:

42. What does the Public Company Accounting Oversight Board (PCAOB) call a deficiency of internal control over financial reporting (ICFR) such that there is a reasonable possibility that a material misstatement of the company’s annual and interim financial statements will not be prevented or detected on a timely basis?

a. Control deficiency
b. Material deficiency
c. Material weakness
d. Significant deficiency

(c) A *material weakness* is a deficiency of internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the company’s annual and interim financial statements will not be prevented or detected on a timely basis. A *significant deficiency* is a deficiency that is less severe than a material weakness; yet important enough to merit attention by those responsible for oversight of the company’s financial reporting. A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. The PCAOB standards don’t use the term material deficiency.

2008 RELEASED AICPA QUESTIONS AND ANSWERS

In September 2008, the AICPA released fifty multiple-choice questions and one simulation relating to the AUD section of the CPA Examination. These questions and their unofficial answers are reproduced here, along with the exclusive Bisk Education explanations. The multiple-choice questions in Problems 1 and 2 were labeled *moderate* and *hard,* respectively, by the AICPA examiners. Problem 3 is the one simulation that was disclosed. The AICPA did not state if these questions ever appeared on any exam, whether they were assigned points or were merely being pretested and earned no points if they did appear on an exam, or if they were now obsolete for some reason. These questions are intended only as a study aid and should not be used to predict the content of future exams. It is the AICPA's policy that released questions will not appear on future exams. These questions have been reproduced as received from the AICPA examiners. If candidates encounter what they believe are errors or ambiguities in questions during the actual exam, they should bring them to the attention of the examiners in accordance with the procedures outlined on the AICPA's Uniform CPA Examination Web site (www.cpa-exam.org).

Problem 1 MULTIPLE-CHOICE QUESTIONS (50 to 63 minutes)

1. On March 1, Green, CPA, expressed an unqualified opinion on the financial statements of Ajax Co. On July 1, Green's internal inspection program discovered that engagement personnel failed to observe Ajax's physical inventory. Green believes that this omission impairs Green's ability to support the unqualified opinion. If Ajax's creditors are currently relying on Green's opinion, Green should first

a. Request Ajax's management to communicate to its creditors that Green's opinion should **not** be relied on.
b. Reissue Green's auditor's report with an explanatory paragraph describing the departure from GAAS.
c. Undertake to apply the alternative procedures that would provide a satisfactory basis for Green's opinion.
d. Advise Ajax's board of directors to disclose this development in its next interim report.

(R/08, AUD, 0600A, #1, 8607)

2. Which of the following procedures would best detect a liability omission by management?

a. Inquiry of senior support staff and recently departed employees
b. Review and check mathematical accuracy of financial statements
c. Review articles of incorporation and corporate bylaws
d. Review purchase contracts and other legal documents (R/08, AUD, C00046A, #2, 8608)

3. Evidence concerning the proper segregation of duties for receiving and depositing cash receipts ordinarily is obtained by

a. Completing an internal control questionnaire that describes the control activities
b. Observing the employees who are performing the control activities
c. Performing substantive tests to verify the details of the bank balance
d. Preparing a flowchart of the duties performed and the entity's available personnel

(R/08, AUD, 1249A, #3, 8609)

4. Which of the following documents are examples of audit evidence generated by the client?

a. Customer purchase orders and bank statements
b. Shipping documents and receiving reports
c. Vendor invoices and packing slips
d. Bills of lading and accounts receivable confirmations (R/08, AUD, A0548A, #4, 8610)

5. Which of the following procedures is ordinarily performed by an accountant during an engagement to compile the financial statements of a nonissuer?

a. Make inquiries of the employees and senior management regarding transactions with related parties.
b. Determine whether there is substantial doubt about the entity's ability to continue as a going concern.
c. Scan the entity's records for the period just after the balance sheet date to identify subsequent events requiring disclosure.
d. Consider whether the financial statements are free from obvious material mistakes in the application of accounting principles.

(R/08, AUD, 1362A, #5, 8611)

6. Which of the following best represents a key control for ensuring sales are properly authorized when accessing control risks for sales?
a. The separation of duties between the billing department and the cash receipts approval department
b. The use of an approved price list to determine unit selling price
c. Copies of approved sales orders sent to the shipping, billing, and accounting departments
d. Sales orders are sent to the credit department for approval (R/08, AUD, C00044A, #6, 8612)

7. When providing limited assurance that the financial statements of a nonissuer require no material modifications to be in accordance with GAAP, the accountant should
a. Assess the risk of material misstatement in the financial statements due to fraud.
b. Perform tests of controls to evaluate the effectiveness of the controls.
c. Understand the accounting principles of the industry in which the entity operates.
d. Communicate with the audit committee regarding material weaknesses in internal control.
(R/08, AUD, 1713A, #7, 8613)

8. In assessing the competence of internal auditors, an independent CPA most likely would obtain information about the
a. Influence of management on the scope of the internal auditors' duties
b. Policies limiting internal auditors from communicating with the audit committee
c. Quality of the internal auditors' working paper documentation
d. Entity's ability to continue as a going concern for a reasonable period of time
(R/08, AUD, 1443A, #8, 8614)

9. Which of the following procedures would an auditor most likely perform to assist in the evaluation of loss contingencies?
a. Checking arithmetic accuracy of the accounting records
b. Performing appropriate analytical procedures
c. Obtaining a letter of audit inquiry from the client's lawyer
d. Reading the financial statements, including footnotes (R/08, AUD, A0917A, #9, 8615)

10. A client maintains a large data center where access is limited to authorized employees. How may an auditor best determine the effectiveness of this control activity?
a. Inspect the policy manual establishing this control activity.
b. Ask the chief technology officer about known problems.
c. Observe whether the data center is monitored.
d. Obtain a list of current data center employees.
(R/08, AUD, 0259A, #10, 8616)

11. Detection risk differs from both control risk and inherent risk in that detection risk
a. Exists independently of the financial statement audit
b. Can be changed at the auditor's discretion
c. Arises from risk factors relating to fraud
d. Should be assessed in nonquantitative terms
(R/08, AUD, 1721A, #11, 8617)

12. 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. Stamped *paid* by the check signer
b. Returned to the vouchers payable department
c. Supported by a vendor's invoice and purchase order
d. Prenumbered and accounted for
(R/08, AUD, 1137A, #12, 8618)

13. In an engagement to review the financial statements of a nonissuer, the accountant most likely would perform which of the following procedures?
a. Physical inspection of inventory
b. Vouching of inventory purchase transactions
c. Analysis of inventory turnover
d. Evaluation of internal control over inventory
(R/08, AUD, A0526A, #13, 8619)

14. An auditor requests a client to send letters of audit inquiry to attorneys who have been consulted concerning litigation, claims, and assessments. The primary reason for this request is to obtain
a. The attorneys' assurance that litigation, claims, and assessments that are probable of assertion are properly accounted for
b. Corroboration of the information furnished by management concerning litigation, claims, and assessments
c. A description of litigation, claims, and assessments that have a reasonable possibility of unfavorable outcomes
d. The opinion of an expert whether any loss contingencies are possible, probable, or remote
(R/08, AUD, 0394A, #14, 8620)

15. Which of the following is an inherent limitation of internal controls?
a. Judgmental sampling
b. Collusion
c. Segregation of duties
d. Employee peer review
(R/08, AUD, A1224A, #15, 8621)

16. If the objective of an auditor's test of details is to detect a possible understatement of sales, the auditor most likely would trace transactions from the
a. Sales invoices to the shipping documents
b. Cash receipts journal to the sales journal
c. Shipping documents to the sales invoices
d. Sales journal to the cash receipts journal
(R/08, AUD, 0546A, #16, 8622)

17. 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. Extend the due dates of existing loans.
b. Operate at increased levels of production.
c. Accelerate expenditures for research and development projects.
d. Issue stock options to key executives.
(R/08, AUD, 0263A, #17, 8623)

18. Which of the following statements is correct regarding a compilation report on financial statements issued in accordance with *Statements on Standards for Accounting and Review Services* (SSARS)?
a. The report should **not** be issued if the accountant is **not** independent from the entity.
b. The report should include a statement indicating that the information is the representation of the accountant.
c. The report should include a description of other procedures performed during the compilation.
d. The date on the report should be the date of completion of the compilation.
(R/08, AUD, A1409A, #18, 8624)

19. The phrase *generally accepted accounting principles* is an accounting term that
a. Includes broad guidelines of general application but **not** detailed practices and procedures
b. Encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time
c. Provides a measure of conventions, rules, and procedures governed by the AICPA
d. Is included in the audit report to indicate that the audit has been conducted in accordance with generally accepted auditing standards (GAAS)
(R/08, AUD, C00108A, #19, 8625)

20. Which of the following circumstances would permit an independent auditor to accept an engagement after the close of the fiscal year?
a. Issuance of a disclaimer of opinion as a result of inability to conduct certain tests required by generally accepted auditing standards due to the timing of acceptance of the engagement
b. Assessment of control risk below the maximum level
c. Receipt of an assertion from the preceding auditor that the entity will be able to continue as a going concern
d. Remedy of limitations resulting from accepting the engagement after the close of the end of the year, such as those relating to the existence of physical inventory
(R/08, AUD, A0325A, #20, 8626)

21. When issuing letters for underwriters, commonly referred to as comfort letters, an accountant may provide negative assurance concerning
a. The absence of any significant deficiencies in internal control
b. The conformity of the entity's unaudited condensed interim financial information with generally accepted accounting principles (GAAP)
c. The results of procedures performed in compiling the entity's financial forecast
d. The compliance of the entity's registration statement with the requirements of the Securities Act of 1933 (R/08, AUD, 0456A, #21, 8627)

22. An accountant is required to comply with the provisions of the *Statements on Standards for Accounting and Review Services* when performing which of the following tasks?
a. Preparing monthly journal entries
b. Providing the client with software to generate financial statements
c. Generating financial statements of a nonissuer
d. Providing a blank financial statement format or template (R/08, AUD, A0156A, #22, 8628)

23. Which of the following statements would be appropriate in an accountant's report on compiled financial statements of a nonissuer prepared in accordance with *Statements on Standards for Accounting and Review Services* (SSARS)?

a. We are not aware of any material modifications that should be made to the accompanying financial statements.
b. A compilation is substantially less in scope than an audit in accordance with generally accepted auditing standards (GAAS).
c. A compilation is limited to presenting in the form of financial statements information that is a representation of management.
d. A compilation is performed to obtain reasonable assurance about whether the financial statements are free from material misstatement.

(R/08, AUD, A0681A, #23, 8629)

24. Quality control policies and procedures that are established to decide whether to accept a new client should provide the CPA firm with reasonable assurance that

a. The CPA firm's duty to the public concerning the acceptance of new clients is satisfied.
b. The likelihood of associating with clients whose management lacks integrity is minimized.
c. Client-prepared schedules that are necessary for the engagement are completed on a timely basis.
d. Sufficient corroborating evidence to support the financial statement assertions is available.

(R/08, AUD, 1705A, #24, 8630)

25. For the fiscal year ending December 31, previous year and the current year, Justin Co. has net sales of $1,000,000 and $2,000,000; average gross receivables of $100,000 and $300,000; and allowance for uncollectible accounts receivable of $30,000 and $50,000, respectively. If the accounts receivable turnover and the ratio of allowance for uncollectible accounts receivable to gross accounts receivable are calculated, which of the following best represents the conclusions to be drawn?

a. Accounts receivable turnovers are 10.0 and 6.6 and the ratios of uncollectible accounts receivable to gross accounts receivable are 0.30 and 0.16, respectively. Examine allowance for possible overstatement of the allowance.
b. Accounts receivable turnovers are 10.0 and 6.6 and the ratios of uncollectible accounts receivable to gross accounts receivable are 0.30 and 0.16, respectively. Examine allowance for possible understatement of the allowance.
c. Accounts receivable turnovers are 14.3 and 8.0 and the ratios of uncollectible accounts receivable to gross accounts receivable is 0.42 and 0.20, respectively. Examine allowance for possible overstatement of the allowance.
d. Accounts receivable turnovers are 14.3 and 8.0 and the ratios of uncollectible accounts receivable to gross accounts receivable are 0.42 and 0.20, respectively. Examine allowance for possible understatement of the allowance.

(R/08, AUD, C00096A, #25, 8631)

Problem 2 ADDITIONAL MULTIPLE-CHOICE QUESTIONS (50 to 63 minutes)

26. Which of the following would be a consideration in planning an auditor's sample for a test of controls?

a. Preliminary judgments about materiality levels
b. The auditor's allowable risk of assessing control risk too high
c. The level of detection risk for the account
d. The auditor's allowable risk of assessing control risk too low

(R/08, AUD, C04951A, #26, amended, 8632)

27. An auditor is auditing a mutual fund company that uses a transfer agent to handle accounting for shareholders. Which of the following actions by the auditor would be most efficient for obtaining information about the transfer agent's internal controls?

a. Review reports on internal control placed in operation and its operating effectiveness produced by the agent's own auditor.
b. Review prior year workpapers to determine whether the number of transactions processed by the agent has materially increased.
c. Perform an audit on the internal control function of the agent.
d. Perform tests of controls on a sample of the audited firm's transactions through the agent.

(R/08, AUD, A1071A, #27, 8633)

28. Which of the following statements is true regarding analytical procedures in a review engagement?
a. Analytical procedures are **not** required to be used as a substantive test.
b. Analytical procedures do **not** involve comparisons of recorded amounts to expected amounts.
c. Analytical procedures are required to be used in the final review stage.
d. Analytical procedures involve the use of both financial and nonfinancial data.
(R/08, AUD, C00095A, #28, 8634)

29. 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*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

(R/08, AUD, 1276A, #29, 8635)

30. An auditor is determining if internal control relative to the revenue cycle of a wholesaling entity is operating effectively in minimizing the failure to prepare sales invoices. The auditor most likely would select a sample of transactions from the population represented by the
a. Cash receipts file
b. Shipping document file
c. Customer order file
d. Sales invoice file
(R/08, AUD, 1447A, #30, 8636)

31. A CPA concludes that the unaudited financial statements on which the CPA is disclaiming an opinion are **not** in conformity with generally accepted accounting principles (GAAP) because management has failed to capitalize leases. The CPA suggests appropriate revisions to the financial statements, but management refuses to accept the CPA's suggestions. Under these circumstances, the CPA ordinarily would
a. Express limited assurance that **no** other material modifications should be made to the financial statements.
b. Restrict the distribution of the CPA's report to management and the entity's board of directors.
c. Issue a qualified opinion or adverse opinion depending on the materiality of the departure from GAAP.
d. Describe the nature of the departure from GAAP in the CPA's report and state the effects on the financial statements, if practicable.
(R/08, AUD, 1883A, #31, 8637)

32. Which of the following procedures would an auditor most likely perform prior to the balance sheet date?
a. Review subsequent events
b. Perform search for unrecorded liabilities
c. Send inquiry letter to client's legal counsel
d. Review detail and test significant travel and entertainment expenses
(R/08, AUD, C04989A, #32, 8638)

33. An audit client failed to maintain copies of its procedures manuals and organizational flowcharts. What should the auditor do in an audit of financial statements?
a. Issue a qualified opinion on the basis of a scope limitation.
b. Document the auditor's understanding of internal controls.
c. Assess control risk at the maximum level.
d. Restrict the auditor's responsibility to assess the effectiveness of controls in the audit engagement letter. (R/08, AUD, A2097A, #33, 8639)

34. Which of the following factors most likely would assist an independent auditor in assessing the objectivity of the internal auditor?
a. The organizational status of the director of internal audit
b. The professional certifications of the internal audit staff
c. The consistency of the internal audit reports with the results of work performed
d. The appropriateness of internal audit conclusions in the circumstances
(R/08, AUD, A0584A, #34, 8640)

35. Auditors try to identify predictable relationships when applying analytical procedures. Relationships involving transactions from which of the following accounts most likely would yield the highest level of evidence?
a. Interest expense
b. Allowance for doubtful accounts
c. Accounts receivable
d. Accounts payable
(R/08, AUD, 2048A, #35, 8641)

36. 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 (R/08, AUD, 0040A, #36, 8642)

37. Which of the following procedures would an auditor most likely perform regarding litigation?
a. Confirm directly with the clerk of the court that the client's litigation is properly disclosed.
b. Discuss with management its policies and procedures for identifying and evaluating litigation.
c. Inspect the legal documents in the client's lawyer's possession regarding pending litigation.
d. Confirm the details of pending litigation with the client's adversaries' legal representatives.
(R/08, AUD, 2169A, #37, 8643)

38. Before reissuing a compilation report on the financial statements of a nonissuer for the prior year, the predecessor accountant is required to
a. Obtain an updated management representation letter from the entity's management.
b. Compare the prior year's financial statements with those of the current year.
c. Review the successor accountant's working papers for matters affecting the prior year.
d. Make inquiries of the entity's lawyers concerning continuing litigation.
(R/08, AUD, 0697A, #38, 8644)

39. Which of the following procedures would an accountant most likely perform during an engagement to review the financial statements of a nonissuer?
a. Review the predecessor accountant's working papers.
b. Inquire of management about related party transactions.
c. Corroborate litigation information with the entity's attorney.
d. Communicate internal control deficiencies to senior management.
(R/08, AUD, 0487A, #39, 8645)

40. Which of the following situations represents a risk factor that relates to misstatements arising from misappropriation of assets?
a. A high turnover of senior management
b. A lack of independent checks
c. A strained relationship between management and the predecessor auditor
d. An inability to generate cash flow from operations (R/08, AUD, A0254A, #40, 8646)

41. Which of the following actions should an accountant take when engaged to compile a company's financial statements in accordance with *Statements on Standards for Accounting and Review Services* (SSARS)?
a. Perform analytical procedures.
b. Express negative assurance on the financial statements.
c. Make management inquiries and examine internal controls.
d. Perform the engagement even though independence is compromised.
(R/08, AUD, A1127A, #41, 8647)

42. Which of the following procedures would a CPA most likely perform when reviewing the financial statements of a nonissuer?
a. Verify that the accounting estimates that could be material to the financial statements have been developed.
b. Obtain an understanding of the entity's internal control components.
c. Assess the entity's ability to continue as a going concern for a reasonable period of time.
d. Make inquiries about actions taken at the board of directors meetings.
(R/08, AUD, 1865A, #42, 8648)

43. In evaluating the reasonableness of an entity's accounting estimates, an auditor most likely concentrates on key factors and assumptions that are
a. Stable and **not** sensitive to variation
b. Objective and **not** susceptible to bias
c. Deviations from historical patterns
d. Similar to industry guidelines
(R/08, AUD, 1438A, #43, 8649)

44. A client decides **not** to make an auditor's proposed adjustments that collectively are **not** material and wants the auditor to issue the report based on the unadjusted numbers. Which of the following statements is correct regarding the financial statement presentation?
a. The financial statements are free from material misstatement, and **no** disclosure is required in the notes to the financial statements.
b. The financial statements do **not** conform with generally accepted accounting principles (GAAP).
c. The financial statements contain unadjusted misstatements that should result in a qualified opinion.
d. The financial statements are free from material misstatement, but disclosure of the proposed adjustments is required in the notes to the financial statements.
(R/08, AUD, A1383A, #44, 8650)

45. A client is a defendant in a patent infringement lawsuit against a major competitor. Which of the following items would **least** likely be included in the attorney's response to the auditor's letter of inquiry?
a. A description of potential litigation in other matters or related to an unfavorable verdict in the patent infringement lawsuit
b. A discussion of case progress and the strategy currently in place by client management to resolve the lawsuit
c. An evaluation of the probability of loss and a statement of the amount or range of loss if an unfavorable outcome is reasonably possible
d. An evaluation of the ability of the client to continue as a going concern if the verdict is unfavorable and maximum damages are awarded
(R/08, AUD, A1562A, #45, 8651)

46. In using the work of a specialist, an auditor may refer to the specialist in the auditor's report if, as a result of the specialist's findings, the auditor
a. Desires to disclose the specialist's findings, which imply that a more thorough audit was performed
b. Makes suggestions to management that are likely to improve the entity's internal control
c. Corroborates another specialist's findings that were consistent with management's assertions
d. Adds an explanatory paragraph to the auditor's report to emphasize an unusually important subsequent event
(R/08, AUD, 1736A, #46, 8652)

47. When an accountant is **not** independent with respect to an entity, which of the following types of compilation reports may be issued?
a. The standard compilation report may be issued, regardless of independence.
b. A compilation report with negative assurance may be issued.
c. A compilation report with special wording that notes the accountant's lack of independence may be issued.
d. A compilation report may be issued if the engagement is upgraded to a review.
(R/08, AUD, A0494A, #47, 8653)

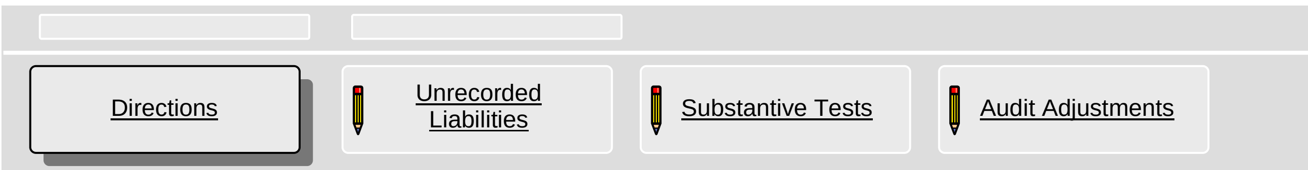
48. Which of the following items would most likely require an adjustment to the financial statements for the year ended December 31, year 1?
a. Uninsured loss of inventories purchased in year 1 as a result of a flood in year 2
b. Settlement of litigation in year 2 over an event that occurred in year 2
c. Loss on an uncollectible trade receivable recorded in year 1 from a customer that declared bankruptcy in year 2
d. Proceeds from a capital stock issuance in year 2 which was being approved by the board of directors in year 1
(R/08, AUD, A2346A, #48, 8654)

49. Which of the following is an element of a CPA firm's quality control policies and procedures applicable to the firm's accounting and auditing practice?
a. Information processing
b. Engagement performance
c. Technology selection
d. Professional skepticism
(R/08, AUD, 1513A, #49, 8655)

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

a. Examine changes in the quoted market prices of investments purchased since the year-end.
b. Compare the latest available interim financial information with the financial statements being reported upon.
c. Apply analytical procedures to the details of the balance sheet accounts that were tested at interim dates.
d. Inquire about payroll checks that were recorded before the year-end but cashed after the year-end. (R/08, AUD, 0395A, #50, 8656)

Problem 3 SIMULATION (40 to 50 minutes)



In the following simulation, you will be asked to complete various tasks. You may use the content in the **Information Tabs** to complete the tasks in the **Work Tabs**.

Information Tabs:

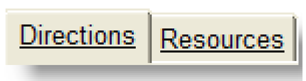


FIG. 1

- Go through each of the **Information Tabs** to familiarize yourself with the simulation content.
- The **Resources** tab will contain information, including formulas and definitions, that may help you to complete the tasks.
- Your simulation may have more **Information Tabs** than those shown in Fig. 1.

Work Tabs:

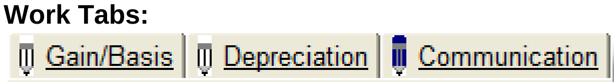


FIG. 2

- **Work Tabs**, to the right of the **Information Tabs**, contain the tasks for you to complete.
- **Work Tabs** contain directions for completing each task—be sure to read these directions carefully.
- The tab names in Fig. 2 are for illustration only—yours may differ.
- Once you complete any part of a task, the pencil for that tab will be shaded (see **Communication** in Fig. 2).
- The shaded pencil does **NOT** indicate that you have completed the entire task.
- You must complete all of the tasks in the **Work Tabs** to receive full credit.

Research/Authoritative Literature Tab:

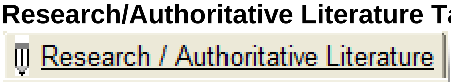


FIG. 3

- This tab contains both the research task and the authoritative literature.
- Detailed instructions for completing the research task, and for using the authoritative literature, appear on this tab.
- You may use the authoritative literature as a resource for completing other tasks.

Note: If you believe you have encountered a software malfunction, report it to the test center staff immediately.

Directions | Unrecorded Liabilities | Substantive Tests | Audit Adjustments

Based on the company and its environment, including its internal control, the auditors assessed the risk of material misstatements to the financial statements, whether due to error or fraud, and designed the nature, timing, and extent of further audit procedures to be performed.

As a result of conducting the above risk assessment procedures, the audit program for year 2 includes the following changes from the audit program for year 1. The company has a calendar year-end and operates only on weekdays.

In conducting the audit procedures for the search for unrecorded liabilities, the materiality/scope for this area was assessed by the auditors at $6,000. Adjustments are only recorded for items equal to, or exceeding materiality. The last day of fieldwork is estimated to be February 1, year 3.

For the items reflected in the following check register, which are **not** recorded in the accounts payable subsidiary ledger at December 31, year 2, determine if each potential liability is recorded in the proper accounting period and also determine the amount that should be journalized, if any. If no action is required, you must enter $0.

For each of the check numbers in the table below, double click on each of the associated shaded cells and select from the lists provided if any action or adjustment is required, as well as, the dollar value of the required adjustment. Each selection may be used once, more than once, or not at all.

Check Register				
Vendor	**Check #**	**Check Date**	**Amount**	**Nature of Expense**
Water World Distributors, Inc.	1333	1/6/year 3	$ 3,500	Water coolers in office and warehouse delivered 12/31/year 2
Daniel Breen, Esquire	1334	1/6/year 3	$ 6,000	Corporate legal services for December, year 2
Telephone Services, Inc.	1335	1/8/year 3	$ 6,500	December, year 2 telephone and computer services
Payroll processing—Paychecks	1336	1/10/year 3	$25,500	Biweekly payroll (12/25/year 2 -1/7/year 3)
Pitt Ohio Trucking Company	1337	1/10/year 3	$45,601	Trucking services 12/4/year 2 - 1/3/year 3, deliveries made evenly throughout the period
Petty cash	1338	1/17/year 3	$ 2,002	Replenish petty cash box
Smith's Forklift Repairs	1339	1/22/year 3	$11,000	Received new forklift on 12/29/year 2, ordered on 12/18/year 2
Glenn's Glass Distribution Center	1340	1/23/year 3	$12,230	Specialty goods ordered 12/20/year 2, delivered 12/31/year 2
Payroll processing—Paychecks	1341	1/24/year 3	$25,500	Biweekly payroll (1/8/year 3 -1/15/year 3)
Daniel Breen, Esquire	1342	2/6/year 3	$ 6,800	Corporate legal services for January, year 3

Check #	Adjustment needed?	Amount
1333		
1334		
1335		
1336		
1337		
1338		
1339		
1340		
1341		
1342		

Selection List for Adjustment Needed

No action required
Adjustment

Selection List for Amount

$0	$7,650
$2,002	$9,900
$2,970	$11,000
$3,500	$12,230
$4,413	$12,750
$6,000	$25,500
$6,500	$41,188
$6,800	$45,601

Directions | Unrecorded Liabilities | Substantive Tests | Audit Adjustments

The auditor determines that each of the following objectives will be part of the company's audit. For each objective, double click on the shaded area and select **two** different substantive tests that provide the best support for the audit objective. A substantive test may be used once, more than once, or not at all.

Audit Objective	Substantive Tests
1. Receivables at the end of year 2 are properly cut off with respect to sales made in year 2.	
2. The aggregate of net receivables in the balance sheet is fairly stated at estimated net realizable value.	
3. Depreciation expense is fairly stated.	
4. Fixed assets included in the balance sheet exist.	

Selection List

A. Request positive confirmation directly from the customer of its balance owed to the company.	I. From the fixed assets subledger, trace a selection of fully depreciated assets from the ledger to the manufacturing floor and check the associated identification number.
B. Test that the income statement agrees to the change of assets minus liabilities and owner's equity.	J. Recalculate the year's depreciation expense.
C. Test the aging in the accounts receivable trial balance.	K. Review the process of assigning expected useful life to machinery with the controller and ask if any assumptions have changed.
D. Trace shipping documents to the related sales invoices and orders, and to entries in the sales journal and accounts receivable subsidiary ledger.	L. Foot the fixed asset subledger.
E. Analyze the historical relationship of bad debt write-offs in comparison with sales and accounts receivable.	M. Vouch additions to the property, plant and equipment subsidiary ledger.
F. Foot the accounts receivable trial balance.	N. Make a physical inspection of major property, plant and equipment acquisitions
G. Foot and cross-foot the sales journal.	O. Foot and cross-foot the purchases journal
H. Identify the last number used in year 2 and the first number used in year 3 for prenumbered shipping documents and prenumbered sales invoices. Trace the respective numbers to postings in the sales journal and accounts receivable subsidiary ledger.	P. Investigate and review cash receipts related to retirements and sales of property, plant and equipment during the year.

Directions | Unrecorded Liabilities | Substantive Tests | Audit Adjustments

The year under audit is year 2.

During the course of the year 2 audit of the company, the auditor discovered the following situations that may or may not require an adjusting journal entry. Each audit finding is independent of any of the other findings. Double click on a shaded space and select the account or accounts that would comprise the adjusting journal entry, if required, to correct the audit finding. Accounts may be used once, more than once, or not at all.

Audit Finding	**Adjusting Journal Entry**	
	Dr.	**Cr.**
1. The bank's confirmation reply regarding the company's line of credit indicated that the December, year 2, interest was unpaid at year-end. Accruals for monthly interest expense have been made for 11 months in year 2 by the company.		
2. Employee overtime pay for hours worked before year-end, but paid in the following year, were **not** recorded in year 2.		
3. In the last week of year 2, the company recorded revenue for services rendered to some clients in year 3.		
4. During year 2, a former client sued the company for inappropriate work. Legal counsel has advised that it is *reasonably possible* that the company will be assessed damages. An amount can be estimated.		
5. At the end of year 2, a major customer filed for bankruptcy.		

Selection List for Audit Findings

Cash	Allowance for Doubtful Accounts
Accounts Receivable	Operating Expenses
Other Current Assets	Interest Expense
Property and Equipment	Other Income
Accounts Payable	Accumulated Depreciation
Accrued Liabilities	
Common Stock	Disclosure but **no** entry required
Revenues	**No** entry or disclosure required

Communication | Research

Your CPA firm has been auditing the financial statements of XYZ Company for several years. Your assistants have approached you and asked if they can omit the confirmation of XYZ's accounts receivable. In a memorandum to your audit team, describe the circumstances under which the confirmation of accounts receivable may be omitted.

Type your communication in the response area below the horizontal line using the word processor provided.

REMINDER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do **not** convey information in the form of a table, bullet point list, or other abbreviated presentation.

Communication | Research

During the year-end audit of Client Mfg., the lead auditor in charge of the audit asks you to provide guidance for discovering material transactions with related parties. What are examples of procedures to recognize material transactions with related parties?

Reminder: On the actual exam, you will use an electronic database of authoritative literature to find and select the reference (appropriate section and paragraph of the relevant guidance). Please see the AICPA's tutorial and sample test on their exam Web site (www.cpa-exam.org).

Paragraph reference answer: ____________________ (R/08, AUD, 8657)

Solution 1 MULTIPLE-CHOICE ANSWERS

1. (c) If the auditor concludes that the omission of a procedure considered necessary at the time of the audit impairs the auditor's present ability to support the previously expressed opinion and there are persons currently relying (such as Ajax's creditors), or likely to rely, on the report, the auditor should promptly *apply* the omitted procedure or *alternative procedures that would provide a satisfactory basis for the opinion.* Only if the auditor discovers, after performing these procedures, that the audit report cannot be supported, would other actions such as the other answer alternatives come into play, depending on the circumstances. (Chapter 28-7-4; 8607; CBT Skill: analysis; CSO: 5.3.2)

2. (d) This is an instance of testing for completeness, i.e., that all transactions and events that should have been recorded have been recorded. The best test for this would be to trace (*review*) information contained in source documents (*purchase contracts and other legal documents*) to the financial statements. Inquiry is not as effective as this tracing procedure. Reviewing the financial statements for mathematical accuracy would not detect an unrecorded liability; this would only provide evidence about recorded liabilities. A company's articles of incorporation and corporate bylaws generally do not contain liability information and they would prove an even less likely source of evidence of recent omissions. (Chapter 25-3-6; 8608; CBT Skill: judgment; CSO: 3.1.5)

3. (b) The best way to obtain evidence about the proper segregation of duties is by *observing the employees who are performing the control activities.* Procedures to verify the details of the bank balance, if they included examining signatures on deposit slips, could indicate which employees prepared the deposits, but this would not provide conclusive evidence as to which employees actually collected (physically handled) the receipts. Flowcharts and internal control questionnaires speak more to the effectiveness of the design rather than the operation of this control, but even if they are based on inquiries about the operation of the control, they do not provide as high a degree of evidence as simply actually observing who does what. (Chapter 23-5-3; 8609; CBT Skill: analysis; CSO: 2.6.0)

4. (b) *Shipping documents* (records of goods shipped by the client) *and receiving reports* (records of goods received by the client) are generated by the client. Customer purchase orders and bank statements are generated externally by the client's customers and the client's financial institutions, respectively. Vendor invoices and packing slips (records of goods shipped to the client) are generated externally by the client's vendors. Bills of lading (records of receipt of goods by a shipper) are generated externally usually by common carriers used by the client. Accounts receivable confirmation *requests* are sent out by the auditor or the client; the confirmations are completed (generated) by the client's customers and returned directly to the auditor by the client's customers. (Chapter 23-5-2; 8610; CBT Skill: understanding; CSO: 3.1.5)

5. (d) When engaged to compile the financial statements of a nonissuer, an accountant should read the *financial statements* and consider whether they appear to be appropriate in form and *free from obvious material* errors. This would include mistakes in the compilation of the financial statements, including arithmetical or clerical mistakes; and *mistakes in the application of accounting principles,* including inadequate disclosure. A compilation does **not** contemplate performing inquiry, analytical procedures or other procedures performed in a review. Accordingly, it would not include performing procedures regarding related party transactions, going concern issues, or subsequent events. (A compilation does **not** provide a basis for expressing any level of assurance on the financial statements.) Note: Even though an accountant is not required to perform these procedures, if going concern or subsequent event issues come to the accountant's attention, the accountant should request that management consider the possible effects on the financial statements. The accountant should then evaluate management's response and consider its effect on the compilation report. (Chapter 31-1-2; 8611; CBT Skill: analysis; CSO: 3.8.0)

6. (d) *Sending sales orders to the credit department for approval* is a key control for ensuring that sales are properly authorized. Although the billing and cash receipts departments should be separate (to reduce the opportunity for any one person to both perpetrate and conceal fraud or errors in the normal course of their duties), their separation does not impact whether sales are properly authorized. Use of an approved price list is a control to ensure the accuracy of sales transactions rather than proper authorization. The receipt of *approved* sales orders by the shipping, billing, and accounting departments occurs after the fact. (Chapter 23-7-1; 8612; CBT Skill: judgment; CSO: 2.7.0)

7. (c) This question states the objective of a review engagement. For a review engagement, an

accountant should *possess a level of knowledge of the accounting principles* and practices *of the industry in which the entity operates* and an understanding of the entity's business that 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 in order for them to be in conformity with GAAP or OCBOA. A review does **not** include assessing fraud risk or evaluating the effectiveness of controls—a review does not even contemplate obtaining an understanding of the entity's internal control. The accountant is not required to communicate the existence of material weaknesses in internal control to the entity's audit committee. (Chapter 31-1-3; 8613; CBT Skill: understanding; CSO: 1.6.0)

8. (c) The assessment of the competence of internal auditors by the auditor should include obtaining information about the *quality of working paper documentation,* reports, and recommendations. Information about the influence of management on the scope of the internal auditor's duties and the policies limiting their communication with the audit committee bear on the assessment of their objectivity rather than their competence. Information about the entity's ability to continue as a going concern would not reflect on the competence of the internal auditors. (Chapter 24-2-2; 8614; CBT Skill: understanding; CSO: 1.10.3)

9. (c) Loss contingencies include those arising from litigation, claims and assessments. A *letter of inquiry to the client's lawyer* is the auditor's primary means of corroboration of the information furnished by management about such matters. The financial statements (including footnotes), which may include accrual or disclosure of loss contingencies, are part of the information furnished by management. Performing appropriate analytical procedures and checking the arithmetic accuracy of the accounting records are not likely to provide information about the evaluation of loss contingencies. (Chapter 24-6-2; 8615; CBT Skill: judgment; CSO: 3.2.0)

10. (c) *Observation* of the application of the control, i.e., *whether the data center is monitored* to limit access, yields the most reliable audit evidence about the effectiveness of this control. The control may not be practiced as it is described in the policy manual. Inquiry of the chief technology officer does not provide as reliable evidence as the auditor's observation of the control's application. Obtaining a list of current data center employees by itself does not provide evidence of the effectiveness of the control's application. (Chapter 23-3-2; 8616; CBT Skill: analysis; CSO: 2.6.0)

11. (b) Detection risk differs from control risk and inherent risk in that it *can be changed at the auditor's discretion*. Detection risk, control risk, and inherent risk make up audit risk. *Detection risk* is the risk that the auditor will not detect a misstatement that exists in a relevant assertion. It is a function of an audit procedure's effectiveness and how the auditor applies the procedure. Accordingly, it can be changed at the auditor's discretion. *Control risk* is the risk that a misstatement that could occur in a relevant assertion will not be prevented or detected on a timely basis by the entity's internal control. *Inherent risk* is the susceptibility of a relevant assertion to a misstatement assuming that there are no related controls. Thus, inherent risk and control risk, rather than detection risk, are the entity's risks, i.e., they exist independently of the audit and cannot be changed at the auditor's discretion. Detection risk arises from the fact that the auditor does not examine 100 percent of an account balance or a class of transactions and other factors (which include the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit result) rather than from fraud risk factors. All three risks can be assessed in quantitative terms, such as percentages, or nonquantitative terms, such as high, medium, or low risk. (Chapter 22-2-4; 8617; CBT Skill: understanding; CSO: 1.9.0)

12. (a) The voucher and all supporting documents should be canceled (*stamped paid*) *by the check signer* to avoid duplicate payments. The return of the voucher to the vouchers payable department provides no control to prevent it from being paid more than once. Confirmation that each voucher is supported by a vendor's invoice and purchase order provides evidence that the payment is based on a valid purchase, but would not stop a duplicate payment. Prenumbering and accounting for vouchers allows confirmation that all vouchers were recorded and should allow the discovery of a duplicate payment, but it would not prevent it. (Chapter 23-7-5; 8618; CBT Skill: judgment; CSO: 2.6.0)

13. (c) In a review, the accountant must apply analytical procedures, such as the *analysis of inventory turnover*. A review does **not** include tests of accounting records through inspection, observation, confirmation, or examination of source documents; or other procedures ordinarily performed in an audit. So the accountant would not perform a physical inspection of inventory or vouch inventory purchase transactions. Nor does a review include obtaining

an understanding of the entity's internal control, so the accountant would not evaluate internal control over inventory. (Chapter 31-1-3; 8619; CBT Skill: analysis; CSO: 3.8.0)

14. (b) The primary reason for a letter of audit inquiry to the client's attorneys is to obtain *corroboration of the information furnished by management concerning litigation, claims, and assessments*. The attorney's legal expertise is sought by the auditor, not the assurance that matters are properly *accounted* for. The letter of inquiry should address two lists; one comprised of *pending* or threatened litigation, claims, and assessments; and the other, *unasserted claims and assessments* that would, if asserted, have a reasonable possibility of an unfavorable outcome. The pending matters list is not limited to those that management believes have a reasonable possibility of an unfavorable outcome. And although an attorney's response does include addressing the description of matters and the evaluation of their likely outcome, the *primary* reason for the auditor's request is to corroborate management's information. The attorney is asked to evaluate the likelihood of an unfavorable outcome, not give an opinion using the terms *possible*, *probable* or *remote*. (Chapter 24-6-2; 8620; CBT Skill: understanding; CSO: 3.3.0)

15. (b) *Collusion* is an inherent limitation of any system of internal control. An internal control system, no matter how well designed and operated, cannot give an entity absolute assurance that its objectives will be met because any system has inherent limitations. Other inherent limitations of internal control are faulty human judgment, human failures that lead to errors or mistakes, and inappropriate management override of controls. Judgmental sampling is part of the application of an auditing procedure; not an inherent limitation of internal control. Segregation of duties and employee peer reviews are examples of controls; not inherent limitations. (Chapter 23-2-1; 8621; CBT Skill: understanding; CSO: 2.4.0)

16. (c) To discover understated (unrecorded) sales, the auditor would most likely trace transactions from *shipping documents to sales invoices*. This would reveal orders that have been shipped, but not billed and is an example of testing for completeness. Vouching from sales invoices to shipping documents (the opposite direction) is a test to substantiate that sales are not overstated (verify their occurrence or existence). Comparing entries between the cash receipts journal and the sales journal would verify that the entries were posted correctly, but it would not locate an unrecorded sale. Note: The sales and cash receipts journals are often combined in one journal. (Chapter 25-3-2; 8622; CBT Skill: analysis; CSO: 3.1.5)

17. (a) The auditor would most likely consider, as a mitigating factor, the entity's plans to *extend the due dates of existing loans.* The extension would immediately allow the entity more time to raise cash and more flexibility in planning expenditures. The auditor would need to conclude that it would be granted by the lender and would provide enough of an increase in available funds to be effective. The auditor would be less likely to consider increased levels of production as a mitigating factor. This would definitely mean an increase of expenditures which might not result in increased profitability. Accelerating expenditures for R & D is even more risky especially when the auditor considers that the benefit would need to occur soon enough to meet the reasonable period criteria, i.e., not to exceed one year beyond the date of the financial statements being audited. Although issuing stock options to key executives is often used to attract talent and motivate management (aligning their interests with those of the shareholders), it is unlikely this would be considered a mitigating factor even though upon their granting the options involve no cash outlay and if exercised, generally produce tax savings. Most plans do not allow the employee to exercise the options for at least a year and then often only a portion of them. (Chapter 28-9-4; 8623; CBT Skill: judgment; CSO: 4.4.0)

18. (d) *The date on the report should be the date of completion of the compilation.* An accountant need **not** be independent with respect to an entity to issue a compilation report. In such a case, the accountant should specifically disclose the lack of independence in the last paragraph of the report; however, the reason for the lack of independence should **not** be included. One of the basic elements of a compilation report is a statement that a compilation is limited to presenting in the form of financial statements information that is the representation of *management* (owners); not the accountant. Any other procedures that the accountant might have performed before or during the compilation engagement should **not** be described in the report. (Chapter 31-1-2; 8624; CBT Skill: understanding; CSO: 5.1.2)

19. (b) The phrase *generally accepted accounting principles* is a technical accounting term that *encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time*. It includes not only broad guidelines of general application, but also detailed practices and procedures. No single

reference source, such as the AICPA, exists for all of GAAP. The first sentence of the scope paragraph of the standard report explicitly states that the audit was conducted in accordance with GAAS; the inclusion of a phrase about adherence to GAAP in the opinion paragraph of the report is not an indirect reference to GAAS. (Chapter 28-1-1; 8625; CBT Skill: judgment; CSO: 1.1.1)

20. (d) *Remedy of limitations resulting from accepting the engagement after the close of the end of the year, such as those relating to the existence of physical inventory* would permit the auditor to accept such an engagement. Although early appointment is preferable, an auditor may accept an engagement near or after the close of the fiscal year. The taking of the inventory could be postponed or failing that, another could be taken for the auditor to observe. If the auditor believes that circumstances are such that acceptance after the close of the fiscal year would preclude an unqualified opinion, the auditor should discuss the possible necessity of a qualified or disclaimer of opinion with the client. This is an example of when candidates need to choose the best answer on the exam. It is much more likely that an auditor would accept an engagement after the close of the client's fiscal year if the determination was made that the resultant limitations could be remedied. The assessment of control risk below the maximum level cannot be determined prior to the acceptance of an engagement and is also not relevant to the issue of whether to accept the engagement after the close of the fiscal year. An auditor cannot rely on a predecessor auditor's assertion about a client's ability to continue as a going concern, setting aside the unlikelihood of receiving such a communication. Further, this is not relevant to the issue of whether to accept the engagement after the close of the fiscal year. (Chapter 22-1-1; 8626; CBT Skill: understanding; CSO: 1.4.0)

21. (b) An accountant may give negative assurance as to whether any material modifications should be made to an entity's *unaudited condensed interim financial information for it to be in conformity with GAAP* when the accountant has conducted a review of the interim financial information in accordance with SAS 100, *Interim Financial Information*. Accountants should **not** mention reports related to internal control in a comfort letter, thus negative assurance regarding the absence of any significant deficiencies in internal control should not be made. Accountants may **not** provide negative assurance on the results of procedures performed in compiling an entity's financial forecast. Accountants provide assistance regarding the financial information contained in a registration statement, not the compliance of the registration statement with the Securities Act of 1933. (Chapter 30-3-2; 8627; CBT Skill: understanding; CSO: 5.2.4)

22. (c) An accountant is required to comply with the provisions of the SSARS when *submitting unaudited financial statements of a nonissuer* to a client or third parties. *Submission of financial statements* is defined as presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software. The other three answer alternatives do not meet this definition. (Chapter 31-1-1; 8628; CBT Skill: judgment; CSO: 1.1.2)

23. (c) One of the basic elements of a report on compiled financial statements is a statement that *a compilation is limited to presenting in the form of financial statements information that is the representation of management* (owners). A statement that the accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with GAAP, other than those modifications, if any, indicated in the report (similar to answer *a*), is a basic element of a *review* report rather than a compilation report. A compilation does **not** provide a basis for expressing any level of assurance on the financial statements being compiled. A statement that a *review* is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements taken as a whole and, accordingly, no such opinion is expressed (similar to answer *b*), is also an element of a review rather than a compilation report. The basic element in a compilation report that addresses the scope of the engagement is a statement that the financial statements have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them. Answer *d* is similar to the statement included in the scope paragraph of the standard *audit* report. Again, a compilation does **not** provide any level of assurance. (Chapter 31-1-2; 8629; CBT Skill: understanding; CSO: 5.1.2)

24. (b) One of the elements of a system of quality control is the *acceptance and continuance of client relationships and specific engagements*. Addressing this includes establishing policies and procedures designed to provide a firm with reasonable assurance that it will *accept or continue relationships with clients only when it has considered the integrity of the client*, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance; and the risk associated with providing professional services in the particular

circumstances. A firm's duty to the public may come into play within this element of quality control in the consideration of the withdrawal from an engagement under certain circumstances, but generally not in regard to the acceptance of a new client. However, the public interest is directly addressed in two other elements of a quality control system: *relevant ethical requirements* and *engagement performance*. Whether the client will meet any agreed-upon obligations such as the timely completion of schedules would probably not yet be known when the acceptance of a new client is being considered and is unlikely to be a factor in any event. Nor is it a quality control issue. Prior to the acceptance of a new client, the auditor can only try to ascertain if there will be sufficient corroborating evidence. Although this would be a consideration in whether to accept a new client and it could be posed that having personnel capable of making this judgment is part of this element of quality control, it is not as important an issue as the integrity of the client. (Chapter 21-4-2; 8630; CBT Skill: understanding; CSO: 1.2.3)

25. (b) Accounts receivable turnovers are 10.0 and 6.6 and the ratios of uncollectible accounts receivable to gross accounts receivable are 0.30 and 0.16, respectively. The auditor should examine the allowance account for possible *understatement.* The calculations are as follows. Prior year accounts receivable turnover: net sales of $1,000,000 divided by average receivables of $100,000 = 10.0. Current year accounts receivable turnover: net sales of $2,000,000 divided by average receivables of $300,000 = *6.6. Prior year ratio of allowance for uncollectible accounts receivable to average accounts receivable: allowance for uncollectible accounts receivable of $30,000 divided by average receivables of $100,000 = 0.30. Current year ratio of allowance for uncollectible accounts receivable to average accounts receivable: allowance for uncollectible accounts receivable of $50,000 divided by average receivables of $300,000 = *0.16. Thus accounts receivable turnover decreased from 10.0 to 6.0 and the ratio of allowance for uncollectible accounts receivable to average accounts receivable also decreased; from 0.30 to 0.16. The lower the rate of accounts receivable turnover, the longer the accounts receivable are being held and thus the less likely they are to be collected. In this situation, one would expect the ratio of the allowance of uncollectible accounts receivable to average accounts receivable to increase. Because it decreased, the auditor should examine the allowance account for possible understatement. *Note: Rather than rounding, the examiners truncated these calculations. (Chapter 24-4-4; 8631; CBT Skill: analysis; CSO: 4.1.0)

Solution 2 ADDITIONAL MULTIPLE-CHOICE ANSWERS

26. (d) When planning an audit sample for a test of controls, the auditor should consider *the auditor's allowable risk of assessing control risk too low*; not too high. The auditor should also consider the relationship of the sample to the objective of the test of controls; the maximum rate of deviations from prescribed controls that would support the planned assessed level of control risk; and characteristics of the population, i.e., the items comprising the account balance or class of transactions of interest. Preliminary judgments about materially levels and the level of detection risk are considerations for planning a sample for a substantive test of details. (Chapter 26-1-6; 8632; CBT Skill: judgment; CSO: 3.1.1)

27. (a) The most efficient method to obtain information about the transfer agent's internal control would be to *review reports on internal control placed in operation and its operating effectiveness produced by the agent's own auditor.* Answers *c* and *d* describe methods of obtaining information that are not as efficient as answer *a*. While a significant increase in the number of transactions processed may bear on the planning of the audit procedures, it doesn't reveal any information about internal controls. (Chapter 30-4-2; 8633; CBT Skill: judgment; CSO: 2.5.0)

28. (d) The analytical procedures the accountant may consider performing when conducting a review of financial statements include *comparing current financial information with relevant nonfinancial information*. In order to obtain a reasonable basis for the expression of limited assurance, the accountant must apply analytical procedures to the financial statements, as well as make inquiries and obtain representations from management. Analytical procedures include comparing recorded amounts, or ratios developed from recorded amounts, to expectations developed by the accountant. Although analytical procedures are required by GAAS to be included in the both the planning and the final review stage of an audit, this is not a requirement of a review. (Chapter 31-1-3; 8634; CBT Skill: analysis; CSO: 4.1.0)

29. (d) A review does **not** include assessing fraud risk nor does it contemplate obtaining an

understanding of the entity's internal control, so the report would not speak to these matters. (Chapter 31-1-3; 8635; CBT Skill: understanding; CSO: 5.1.2)

30. (b) The auditor should make the selection from the *shipping document file*. Attempting to match shipping documents to invoices would reveal goods shipped that were not invoiced. The cash receipts file contains evidence of payments, so it would be highly unlikely to discover payments received from customers who weren't billed. The customer order file would be a workable but inefficient choice by the auditor because normally goods are not invoiced until they are shipped, so it would involve checking shipping documents as well to confirm the sale. The sales invoice file would not be used because the auditor is looking for sales that were not invoiced. (Chapter 23-7-1; 8636; CBT Skill: analysis; CSO: 2.6.0)

31. (d) If the accountant concludes that the unaudited financial statements on which the accountant is disclaiming an opinion are **not** in conformity with GAAP, the accountant should suggest appropriate revision; failing that, the accountant should *describe the nature of the departure in the report and, if practicable, state the effects on the financial statements* or include the necessary information for adequate disclosure. When disclaiming an opinion, no assurance can be expressed. Restricting the distribution of the report is not an adequate remedy. The accountant cannot issue a qualified or adverse opinion on unaudited financial statements. (Chapter 28-8-5; 8637; CBT Skill: analysis; CSO: 5.1.1)

32. (d) The *review of travel and entertainment expenses* can be done *prior* to the balance sheet date; however, when substantive procedures are performed at an interim date, the auditor should perform further audit procedures to cover the remaining period that provide a reasonable basis for extending the audit conclusion from the interim date to the balance sheet date. Various phases of an audit are completed during the subsequent period that extends from after the balance sheet date to the date of the audit report. These include the other answer alternatives: review of subsequent events (self-explanatory), the search for unrecorded liabilities, and inquiry of the client's legal counsel. Certain procedures are applied to transactions occurring after the balance sheet date such as the examination of data to assure that proper cutoffs have been made and the examination of data that would provide information to aid the auditor in the evaluation of the assets and liabilities as of the balance sheet date. These procedures would include the search through these post balance sheet transactions for evidence of liabilities that existed at the balance sheet date, but were not recorded. The attorney's response should include coverage of as much of this subsequent period as possible, i.e., have an effective date (the latest date of the period covered by the response) as close to the date of the auditor's report as practicable. Note: As a practical matter, an auditor may choose to send an initial request to the attorney earlier in the audit, so that the completion of the audit is not delayed, with the understanding that an update will be needed close to the report date. (Chapter 25-1-3; 8638; CBT Skill: analysis; CSO: 3.1.7)

33. (b) *The auditor should document key elements of her/his understanding of internal control* regardless of the client's records. The client's failure to do so does not constitute a scope limitation; necessitate that the auditor assess control risk at the maximum level; nor restrict the auditor's responsibility to assess the effectiveness of controls. (Chapter 23-2-5; 8639; CBT Skill: judgment; CSO: 2.3.0)

34. (a) When assessing the internal auditors' objectivity, the auditor should obtain information about such factors as *the organizational status of the director of the internal audit* function. The professional certifications of the internal audit staff is a factor to consider when assessing their competence; not their objectivity. Answer alternatives *c* and *d* are factors to consider when developing evaluation procedures for testing the effectiveness of internal auditors' work rather than their objectivity. (Chapter 24-2-2; 8640; CBT Skill: understanding; CSO: 1.10.3)

35. (a) Relationships involving income statement accounts, such as *interest expense,* tend to be more predictable than relationships involving only balance sheet accounts because income statement accounts represent transactions over a period of time, whereas balance sheet accounts represent amounts as of a point in time. (Chapter 24-4-4; 8641; CBT Skill: analysis; CSO: 3.1.2)

36. (d) *Neither I nor II.* An accountant is required to comply with the provisions of the SSARS when submitting unaudited financial statements of a nonissuer to a client or third parties. *Submission of financial statements* is defined as presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software. Neither I nor II meets this definition. (Chapter 31-1-1; 8642; CBT Skill: understanding; CSO: 1.1.2)

37. (b) The auditor's procedures should include a *discussion with management about the policies and*

procedures adopted for identifying, evaluating, and accounting *for litigation,* claims, and assessments. The events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity. Accordingly, management is the primary source of information about such matters. It is the auditor's responsibility to conclude whether the client's litigation is properly disclosed. The auditor requests the client's attorney's opinion on this, not the clerk of the court. The clerk of the court would not have the information needed. The auditor would examine documents in the client's possession; not the lawyer's possession. The auditor would not likely inspect documents in the client's lawyer's possession due to confidentiality considerations. If the attorney's response does not provide enough information, the auditor would arrange a conference with the attorney rather than request documentation. It would not be appropriate for the auditor to contact the client's adversaries' legal representatives. (Chapter 24-6-1; 8643; CBT Skill: analysis; CSO: 3.2.0)

38. (b) Before reissuing a compilation (or a review report) of a nonissuer on the financial statements of a prior period, the predecessor accountant should read the financial statements of the current period and the successor's report; *compare the prior period financial statements* with those previously issued and *with those of the current period;* and obtain a letter from the successor that indicates whether s/he is aware of any matter that might have a material effect on the financial statements, including disclosures, reported on by the predecessor. The other answer alternatives are not required. Note: The predecessor should **not** refer to the letter from the successor or the successor's report in the reissued report. (Chapter 31-2-4; 8644; CBT Skill: understanding; CSO: 5.1.2)

39. (b) A review does include making *inquiries of management which should include asking about related party transactions*. The successor accountant may wish to review the predecessor's working papers relating to matters of continuing accounting significance and those relating to contingencies. As this is not a requirement, as are inquiries of management, it is not as likely to be performed. In a review the accountant is ordinarily **not** required to corroborate management's responses with other evidence, so it is not likely that the accountant would contact the entity's attorney. A review does **not** contemplate obtaining an understanding of the entity's internal control, thus communication of internal control deficiencies to senior management would not be likely. (Chapter 31-1-3; 8645; CBT Skill: analysis; CSO: 3.8.0)

40. (b) *A lack of independent checks* or inadequate segregation of duties is one of the risk factors associated with misstatements arising from misappropriation of assets. The other answer alternatives are risk factors relating to misstatements arising from fraudulent financial reporting. (Chapter 22-4-2; 8646; CBT Skill: understanding; CSO: 1.9.0)

41. (d) *An accountant need* ***not*** *be independent* with respect to an entity to issue a compilation report. In such a case, the accountant should specifically disclose the lack of independence in the last paragraph of the report; however, the reason for the lack of independence should **not** be included. A compilation does **not** include performing analytical procedures. A compilation does **not** provide a basis for expressing any level of assurance on the financial statements being compiled. A compilation does **not** include making management inquiries nor does it contemplate gaining an understanding of an entity's internal control. (Chapter 31-1-2; 8647; CBT Skill: understanding; CSO: 1.1.2)

42. (d) When reviewing the financial statements of a nonissuer, an accountant should *make inquiries about actions taken at the board of directors meetings*. Making inquiries of management along with applying analytical procedures and obtaining representations from management are required in order to obtain a reasonable basis for the expression of limited assurance. A review does **not** include verification of accounting estimates or tests of accounting records and procedures ordinarily performed in an audit. A review does **not** contemplate obtaining an understanding of an entity's internal control. A review does **not** include the assessment of an entity's ability to continue as a going concern; however, during the performance of a review (or a compilation) it may come to the attention of the accountant that there may be such an uncertainty. If so, the accountant should request that management consider the possible effects on the financial statements, including related disclosures. (Chapter 31-1-3; 8648; CBT Skill: analysis; CSO: 3.8.0)

43. (c) In evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are *deviations from historical patterns*; sensitive to variations (not stable and insensitive to variations); subjective and susceptible to misstatement and bias (not the opposite); and, of course, significant to the accounting estimate. The auditor would expect the estimates to be consistent with industry guidelines, so estimates that did

not conform would bear more scrutiny to obtain evidence that the variation was reasonable under the circumstances. (Chapter 25-3-10; 8649; CBT Skill: understanding; CSO: 1.11.2)

44. (a) In the situation described, *the financial statements are free from material misstatement, and **no** disclosure is required in the notes to the financial statements.* An unqualified opinion states that the financial statements present fairly, *in all material respects,* the financial position, results of operations, and cash flows of the entity in conformity with GAAP. (Chapter 28-2-1; 8650; CBT Skill: judgment; CSO: 4.3.0)

45. (d) *An auditor would not seek an evaluation of the client's ability to continue as a going concern from an attorney* regardless of the cause of the client's financial difficulties; that is the auditor's responsibility and does not involve legal expertise. Answer alternatives *a-c* would be likely to be covered in the client's attorney's response to a letter of audit inquiry. (Chapter 24-6-2; 8651; CBT Skill: understanding; CSO: 3.3.0)

46. (d) The auditor may, as a result of the report or findings of the specialist, decide to *add explanatory language to a standard report (for example, to emphasize an unusually important subsequent event)* 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. *Otherwise*, the auditor should **not** refer to the work or findings of the specialist. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference. (Chapter 24-5-5; 8652; CBT Skill: judgment; CSO: 1.10.2)

47. (c) When an accountant is **not** independent with respect to an entity, *a compilation report with special wording that notes the accountant's lack of independence may be issued.* The accountant should specifically disclose the lack of independence in the last paragraph of the report. However, the reason for the lack of independence should **not** be described. Regardless of the accountant's independence, a compilation does **not** provide a basis for expressing any level of assurance on the financial statements being compiled. There is no point in upgrading the engagement when the accountant lacks independence. Upgrading the engagement does **not** change the requirement for disclosure of the lack of independence in a compilation report. (An accountant is *precluded* from issuing a *review* report for an entity with respect to which the accountant is **not** independent.) (Chapter 31-1-2; 8653; CBT Skill: understanding; CSO: 5.1.2)

48. (c) *A loss on an uncollectible trade receivable recorded in year 1 from a customer that declared bankruptcy in year 2* would most likely require an adjustment to the financial statements. Auditors must consider two types of subsequent events. The first type requires adjustment of the financial statements because it provides evidence about conditions that existed at the balance sheet date. A loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance sheet date would be indicative of conditions existing at the balance sheet date. A bankruptcy after the balance sheet date is the classic example of an event that represents the culmination of conditions that existed over a relatively long period of time as opposed to a sudden event like a fire or flood that occurred after the balance sheet date. The second type of subsequent event provides evidence about conditions that did **not** exist at the balance sheet date and does **not** require adjustment of the financial statements, however due to their nature; some of them may require disclosure to keep the financial statements from being misleading. The other answer alternatives are examples of the second type of subsequent event and they are all also examples of events that would require disclosure. (Chapter 28-7-2; 8654; CBT Skill: analysis; CSO: 3.4.0)

49. (b) *Engagement performance* is one of the elements of a firm's system of quality control. The firm's quality control system should include policies and procedures addressing it and the other elements which are: leadership responsibilities for quality within the firm; relevant ethical requirements; acceptance and continuance of client relationships and specific engagements; human resources; and monitoring. Information processing, technology selection, and professional skepticism are not defined elements of a firm's quality control system. (Chapter 21-4-2; 8655; CBT Skill: understanding; CSO: 1.2.3)

50. (b) The auditor generally should *compare the latest available interim financial information with the financial statements being reported upon.* This is an example of a procedure to find events occurring in the period subsequent to the balance sheet date, but prior to the issuance of the audit report, which may require adjustment to or disclosure in the financial statements. Changes in the market prices

of investments purchased and recorded after the year-end are not relevant because the investments are appropriately not a part of the current year's financial statements. The application of analytical procedures to the details of balance sheet accounts that were tested at interim dates is done so that evidence can be obtained for the extension of the conclusions made at the time of the interim tests to the period end—it is not part of the subsequent period testing. When payroll checks (appropriately recorded as expense in the current year) were cashed does not affect the financial statements. (Chapter 28-7-2; 8656; CBT Skill: analysis; CSO: 3.4.0)

Solution 3 SIMULATION ANSWER

Response #1: Unrecorded Liabilities (5 points)

Check # 1333 $0

The amount of this check ($3,500) is lower than the $6,000 materiality level for adjustments set by the auditors for unrecorded liabilities; otherwise an adjustment would have been needed.

Check # 1334 $6,000

This represents an expense for year 2, paid in year 3, which is equal to the materiality level; an adjustment (accrual of expense) is needed.

Check # 1335 $6,500

This represents an expense for year 2, paid in year 3, which exceeds the materiality level; an adjustment (accrual of expense) is needed.

Check # 1336 $12,750

The portion of this check that represents the salary expense for the period December 25 through December 31, year 2 is an expense for year 2, paid in year 3. The only information the problem gives you is that it is a biweekly payroll. Halving the amount of the check ($25,500/2 = $12,750) is a reasonable assumption to arrive at the amount of the adjustment (accrual of expense) needed.

Check # 1337 $41,188

The portion of this check that represents the delivery expense for the period December 4 through December 31, year 2 is an expense for year 2, paid in year 3. The problem states that deliveries are made evenly throughout the period. The expense covers a period of 31 days (December 4, year 2 through January 3, year 3), 28 of which were part of year 2; thus the calculation for the amount of the adjustment (accrual of expense) needed would be (($45,601 / 31) × 28) = $41,188.

Check # 1338 $0

This amount of this check ($2,002) is lower than the $6,000 materiality level for adjustments set by the auditors for unrecorded liabilities; no adjustment is needed.

Check # 1339 $11,000

This represents an unrecorded liability for year 2 (when the forklift was ordered and received), which exceeds the materiality level; an adjustment (recording of the asset and related payable) is needed.

Check # 1340 $12,230

This represents an unrecorded liability for year 2 (when the goods were ordered and received) which exceeds the materiality level; an adjustment (recording of the purchase and related payable) is needed.

Check # 1341 $0

No adjustment is needed; this represents year 3 salary expense, paid in year 3.

Check # 1342 $0

No adjustment is needed; this represents an expense for year 3, paid in year 3.

Response #2: Substantive Tests (8 points)

1. D, H

   - Any shipping documents dated year 3 should not be invoiced (recorded as sales) in year 2; any shipping documents dated year 2 should be posted to the year 2 sales journal and accounts receivable subsidiary ledger.

   - Accounting for the prenumbered documents in each year's postings will determine if proper cutoff occurred.

2. C. E

    - If the aging of accounts receivable is not accurate, the allowance for uncollectible accounts receivable won't be either; thus the net realizable value of receivables will not be fairly stated.

    - Comparison and the resulting analysis of the current year's relationship to prior years is a test of the reasonableness of the current year's relationship.

3. J, K

    - The recalculation of depreciation expense will confirm its mathematical accuracy and that the expense is allocated to the correct year.

    - This review will confirm that the methods and estimates are appropriate, reasonable, and consistently applied.

4. N. M

    - Testing (vouching) for existence by physically inspecting the acquisitions which are included in the balance sheet will confirm that fixed assets are not overstated,

    - This is another procedure to determine if the assets included in the balance sheet actually exist.

Response #3: Audit Adjustments (5 points)

1. Dr. Interest Expense
   Cr. Accrued Liabilities
   To record interest expense for December

2. Dr. Operating Expenses
   Cr. Accrued Liabilities
   To record year 2 salary expense paid in year 3

3. Dr. Revenues
   Cr. Accounts Receivable
   To adjust revenue for year 3 sales recorded in year 2

4. Disclosure, but no entry required.

   When the loss is *reasonably possible*, rather than *probable*, accrual would be inappropriate, but disclosure of the nature of the contingency is required.

5. Dr. Operating Expenses
   Cr. Allowance for Doubtful Accounts
   To record the increase in bad debt expense

Response #4: Communication (10 points)

To: Audit Team

From: Senior Auditor

Re: Conditions for the Allowable Omission of Accounts Receivable Confirmations

Confirmation of accounts receivable is a **generally accepted auditing procedure.** Generally, evidence obtained from **third parties** will provide us with **higher**-quality **audit evidence** than we would typically find available within our client's records. Thus, there is a **presumption** that we should confirm accounts receivable unless we find one of the following conditions to be the case.

If accounts receivable are **immaterial to the financial statements**, then it would be acceptable not to confirm them.

Or, if we knew that the use of confirmations would be **ineffective**, we could omit them. For example, if our prior years' working papers indicated that last year's **response rate** was unsatisfactory or we had reason to believe that the responses would probably be **unreliable**.

And finally, we could omit them if our combined assessed level of **inherent risk** and **control risk** was **low** enough that when combined with **other substantive tests of details** or **analytical procedures**, we concluded that **audit risk** would be reduced sufficiently for the applicable financial statement **assertions**. However, usually it takes both confirmations *and* other substantive procedures combined to reduce audit risk for these assertions to an acceptably low level.

Additionally, should we omit them; we would need to document how we overcame the presumption to perform them.

Response #5: Research (2 points)

Paragraph Reference Answer: AU 334.08

"The following procedures are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

a. Provide audit personnel performing segments of the audit or auditing and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their audits.

b. Review the minutes of meetings of the board of directors and executive or operating committees for information about material transactions authorized or discussed at their meetings.

c. Review proxy and other material filed with the Securities and Exchange Commission and comparable data filed with other regulatory agencies for information about material transactions with related parties.

d. Review conflict-of-interests statements obtained by the company from its management.

e. Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships.

f. Consider whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing accounting, management or other services at no charge or a major stockholder absorbing corporate expenses.

g. Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.

h. Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.

i. Review invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related party transactions.

j. Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity."

2009 RELEASED AICPA QUESTIONS AND ANSWERS

In April 2009, the AICPA released fifty multiple-choice questions and one simulation relating to the AUD section of the CPA Examination. These questions and their unofficial answers are reproduced here, along with the exclusive Bisk Education explanations. The multiple-choice questions in Problems 1 and 2 were labeled *moderate* and *hard*, respectively, by the AICPA examiners. Problem 3 is the one simulation that was disclosed. The AICPA did not state if these questions ever appeared on any exam, whether they were assigned points or were merely being pretested and earned no points if they did appear on an exam, or if they were now obsolete for some reason. These questions are intended only as a study aid and should not be used to predict the content of future exams. It is the AICPA's policy that released questions will not appear on future exams. These questions have been reproduced as received from the AICPA examiners. If candidates encounter what they believe are errors or ambiguities in questions during the actual exam, they should bring them to the attention of the examiners in accordance with the procedures outlined on the AICPA's Uniform CPA Examination Web site (www.cpa-exam.org).

Problem 1 MULTIPLE-CHOICE QUESTIONS (50 to 63 minutes)

1. Which of the following is an analytical procedure that an auditor most likely would perform during the final review stage of an audit?

a. Comparing each individual expense account balance with the relevant budgeted amounts and investigating any significant variations
b. Testing the effectiveness of internal control procedures that appear to be suitably designed to prevent or detect material misstatements
c. Reading the financial statements and considering whether there are any unusual or unexpected balances that were **not** previously identified
d. Calculating each individual expense account balance as a percentage of total entity expenses and comparing the results with industry averages

(R/09, AUD, 0258A, #1, 8801)

2. Accepting an engagement to compile an entity's financial projection most likely would be inappropriate if the projection is to be included in a(an)

a. Mortgage application for the purpose of expanding the entity's facilities
b. Offering statement of the entity's initial public offering of common stock
c. Comprehensive document to be used in negotiating a new labor contract
d. Report to the audit committee that is **not** sent to the stockholders

(R/09, AUD, 1105A, #2, 8802)

3. Which of the following procedures is an accountant required to perform when reviewing the financial statements of a nonpublic entity in accordance with Statements on Standards for Accounting and Review Services (SSARS)?

a. Assess control risk
b. Obtain a management representation letter
c. Confirm account balances
d. Perform a physical inventory observation

(R/09, AUD, A0416A, #3, 8803)

4. A CPA firm is completing the fieldwork for an audit of Swenson Co. for the current year ended December 31. The manager in charge of the audit is performing the final steps in the evidence accumulation phase of the audit and notes that there have been several changes in Swenson during the year under audit. Which of the following items would indicate there could be substantial doubt about Swenson's ability to continue as a going concern for a reasonable period of time?

a. Cash infusion by a venture capital firm
b. Recurring working capital shortages
c. A lack of significant contracts with new customers
d. Term debt refinanced with a new bank

(R/09, AUD, C00099A, #4, 8804)

5. The blank form of accounts receivable confirmations may be **less** efficient than the positive form because

a. Shipping documents need to be inspected.
b. Recipients may sign the forms without proper investigation.
c. More nonresponses to the requests are likely to occur.
d. Subsequent cash receipts need to be verified.

(R/09, AUD, 1554A, #5, 8805)

6. An accountant agrees to the client's request to change an engagement from a review to a compilation of financial statements. The compilation report should include
a. No reference to the original engagement
b. Reference to a departure from GAAS
c. Scope limitations that may have resulted in the change of engagement
d. Information about review procedures already performed (R/09, AUD, A0298A, #6, 8806)

7. Which of the following describes a weakness in accounts payable procedures?
a. The accounts payable clerk files invoices and supporting documentation after payment.
b. The accounts payable clerk manually verifies arithmetic on the vendor invoice.
c. The accounts payable system compares the receiving report to the vendor invoice.
d. The accounts payable manager issues purchase orders. (R/09, AUD, A2440A, #7, 8807)

8. A successor auditor's inquiries of the predecessor auditor should include questions regarding
a. The predecessor's evaluation of audit risk and judgment about materiality
b. Subsequent events that occurred since the predecessor's audit report was issued
c. The predecessor's understanding as to the reasons for the change in auditors
d. The predecessor's knowledge of accounting matters of continuing significance
(R/09, AUD, 1609A, #8, 8808)

9. Which of the following most likely would cause an auditor to consider whether a client's financial statements contain material misstatements?
a. Management did **not** disclose to the auditor that it consulted with other accountants about significant accounting matters.
b. The chief financial officer will **not** sign the management representation letter until the last day of the auditor's fieldwork.
c. Audit trails of computer-generated transactions exist only for a short time.
d. The results of an analytical procedure disclose unexpected differences.
(R/09, AUD, C05022A, #9, 8809)

10. Which of the following statements is correct regarding accounting estimates?
a. The auditor's objective is to evaluate whether accounting estimates are reasonable in the circumstances.
b. Accounting estimates should be used when data concerning past events can be accumulated in a timely, cost-effective manner.
c. An important accounting estimate is management's listing of accounts receivable greater than 90 days past due.
d. Accounting estimates should **not** be used when the outcome of future events related to the estimated item is unknown.
(R/09, AUD, A0670A, #10, 8810)

11. A practitioner has been engaged to apply agreed-upon procedures in accordance with Statements on Standards for Attestation Engagements (SSAE) to prospective financial statements. Which of the following conditions must be met for the practitioner to perform the engagement?
a. The prospective financial statement includes a summary of significant accounting policies.
b. The practitioner takes responsibility for the sufficiency of the agreed-upon procedures.
c. The practitioner and specified parties agree upon the procedures to be performed by the practitioner.
d. The practitioner reports on the criteria to be used in the determination of findings.
(R/09, AUD, A1603A, #11, 8811)

12. A test of a payroll system involved comparing an individual's number of overtime hours a week with an average of weekly overtime during a similar period in a prior year and evaluating the results. This is an example of what type of test?
a. Range test
b. Detail test
c. Category test
d. Reasonableness test
(R/09, AUD, C04942A, #12, 8812)

13. Which of the following is an analytical procedure that an auditor most likely would perform when planning an audit?
a. Confirming a sample of accounts payable
b. Scanning payroll files for terminated employees
c. Comparing current year balances to budgeted balances
d. Recalculating interest expense based on notes payable balances
(R/09, AUD, C04973A, #13, 8813)

14. Which of the following statements is correct concerning an auditor's use of the work of an actuary in assessing a client's pension obligations?
a. The auditor is required to understand the objectives and scope of the actuary's work.
b. The reasonableness of the actuary's assumptions is strictly the auditor's responsibility.
c. The client is required to consent to the auditor's use of the actuary's work.
d. If the actuary has a relationship with the client, the auditor may **not** use the actuary's work.
(R/09, AUD, 0925A, #14, 8814)

15. Which of the following titles would be considered suitable for financial statements that are prepared on a cash basis?
a. Income statement
b. Statement of operations
c. Statement of revenues collected and expenses paid
d. Statement of cash flows
(R/09, AUD, A0108A, #15, 8815)

16. Which of the following could be difficult to determine because electronic evidence may **not** be retrievable after a specific period?
a. The acceptance level of detection risk
b. The timing of control and substantive tests
c. Whether to adopt substantive or reliance test strategies
d. The assessed level of inherent risk
(R/09, AUD, A2086A, #16, 8816)

17. The purpose of establishing quality control policies and procedures for deciding whether to accept or continue a client relationship is to
a. Monitor the risk factors concerning misstatements arising from the misappropriation of assets
b. Provide reasonable assurance that personnel are adequately trained to fulfill their responsibilities
c. Minimize the likelihood of associating with clients whose management lacks integrity
d. Document objective criteria for the CPA firm's responses to peer review comments
(R/09, AUD, 0811A, #17, 8817)

18. Which of the following situations most likely could lead to an embezzlement scheme?
a. The accounts receivable bookkeeper receives a list of payments prepared by the cashier and personally makes entries in the customers' accounts receivable subsidiary ledger.
b. Each vendor invoice is matched with the related purchase order and receiving report by the vouchers payable bookkeeper who personally approves the voucher for payment.
c. Access to blank checks and signature plates is restricted to the cash disbursements bookkeeper who personally reconciles the monthly bank statement.
d. Vouchers and supporting documentation are examined and then canceled by the treasurer who personally mails the checks to vendors.
(R/09, AUD, 0197A, #18, 8818)

19. Independence is **not** required on which of the following types of engagements?
a. Audit
b. Review
c. Compilation
d. Agreed-upon procedures
(R/09, AUD, C01154A, #19, 8819)

20. An accountant's compilation report on a financial forecast should include a statement that
a. The hypothetical assumptions used in the forecast are reasonable in the circumstances.
b. The forecast should be read only in conjunction with the audited historical financial statements.
c. The accountant expresses only limited assurance on the forecasted statements and their assumptions.
d. There will usually be differences between the forecasted and actual results.
(R/09, AUD, 0382A, #20, 8820)

21. Which of the following actions should the auditor take in response to discovering a deviation from the prescribed control procedure?
a. Make inquiries to understand the potential consequence of the deviation
b. Assume that the deviation is an isolated occurrence without audit significance
c. Report the matter to the next higher level of authority within the entity
d. Increase sample size of tests of controls
(R/09, AUD, A3061A, #21, 8821)

22. Which of the following events **least** likely would indicate the existence of related party transactions?
a. Making a loan with **no** scheduled date for the funds to be repaid
b. Maintaining compensating balance arrangements for the benefit of principal stockholders
c. Borrowing funds at an interest rate significantly below prevailing market rates
d. Writing off obsolete inventory to net realizable value just before year-end
(R/09, AUD, 0354A, #22, 8822)

23. As part of the process of observing a client's physical inventories, an auditor should be alert to
a. The inclusion of any obsolete or damaged goods
b. Any change in the method of pricing from prior years
c. The existence of outstanding purchase commitments
d. The verification of inventory values assigned to goods in process
(R/09, AUD, 0234A, #23, 8823)

24. After issuing an auditor's report, an auditor has **no** obligation to make continuing inquiries concerning audited financial statements **unless**
a. Information about a material transaction that occurred just after the auditor's report was issued is deemed to be reliable.
b. A final resolution is made of a contingent liability that had been disclosed in the financial statements.
c. Information that existed at the report date and may affect the report comes to the auditor's attention.
d. An event occurs just after the auditor's report was issued that affects the entity's ability to continue as a going concern.
(R/09, AUD, 0299A, #24, 8824)

25. Which of the following statements is correct regarding a review of a nonpublic entity's financial statements in accordance with Statements on Standards for Accounting and Review Services (SSARS)?
a. The accountant is required to assess the risk of fraud.
b. It is **not** necessary for the accountant to obtain a management representation letter.
c. An opinion is expressed in the review report.
d. The accountant must be independent to issue the review report.
(R/09, AUD, A0465A, #25, 8825)

Problem 2 ADDITIONAL MULTIPLE-CHOICE QUESTIONS (50 to 63 minutes)

26. In obtaining written representations from management, materiality limits ordinarily would apply to representations related to
a. Amounts concerning related party transactions
b. Irregularities involving members of management
c. The availability of financial records
d. The completeness of minutes of directors' meetings (R/09, AUD, 0251A, #26, 8826)

27. As a result of sampling procedures applied as tests of controls, an auditor incorrectly assesses control risk higher than appropriate. The most likely explanation for this situation is that
a. 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.
b. 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.
c. The deviation rates of both the auditor's sample and the population exceed the tolerable rate.
d. The deviation rates of both the auditor's sample and the population are **less** than the tolerable rate. (R/09, AUD, 0065A, #27, 8827)

28. An accountant has been engaged to compile the financial statements of a nonpublic entity. The financial statements contain many departures from GAAP because of inadequacies in the accounting records. The accountant believes that modification of the compilation report is not adequate to indicate the deficiencies. Under these circumstances, the accountant should

a. Inform management that the engagement can proceed only if distribution of the accountant's report is restricted to internal use
b. Withdraw from the engagement and provide **no** further service concerning these financial statements
c. Quantify the effects of the departures from GAAP and describe the departures from GAAP in a special report
d. Obtain written representations from management that the financial statements will **not** be used to obtain credit from financial institutions

(R/09, AUD, 1687A, #28, 8828)

29. Under which of the following circumstances would the expression of a disclaimer of opinion be inappropriate?

a. The auditor is unable to obtain the audited financial statements of a consolidated investee.
b. Management does **not** provide reasonable justification for a change in accounting principles.
c. The company failed to make a count of its physical inventory during the year and the auditor was unable to apply alternative procedures to verify inventory quantities.
d. Management refuses to allow the auditor to have access to the company's canceled checks and bank statements. (R/09, AUD, 0668A, #29, 8829)

30. According to the third standard of fieldwork, which of the following terms identifies a requirement for audit evidence?

a. Appropriate
b. Adequate
c. Reasonable
d. Disconfirming (R/09, AUD, A2527A, #30, 8830)

31. When performing analytical procedures in the planning stage, the auditor most likely would develop expectations by reviewing which of the following sources of information?

a. Unaudited information from internal quarterly reports
b. Various account assertions in the planning memorandum
c. Comments in the prior year's management letter
d. The control risk assessment relating to specific financial assertions

(R/09, AUD, A0387A, #31, 8831)

32. An auditor's decision whether to apply analytical procedures as substantive tests usually is determined by the

a. Availability of documentary evidence that should be verified
b. Extent of accounting estimates used in preparing the financial statements
c. Precision and reliability of the data used to develop expectations
d. Number of transactions recorded just before and just after the year-end

(R/09, AUD, 1846A, #32, 8832)

33. In a financial statement audit, inherent risk is evaluated to help an auditor assess which of the following?

a. The internal audit department's objectivity in reporting a material misstatement of a financial statement assertion it detects to the audit committee
b. The risk that the internal control system will **not** detect a material misstatement of a financial statement assertion
c. The risk that the audit procedures implemented will **not** detect a material misstatement of a financial statement assertion
d. The susceptibility of a financial statement assertion to a material misstatement assuming there are **no** related controls

(R/09, AUD, C04944A, #33, 8833)

34. Which of the following statements most likely would be included in an engagement letter from an auditor to a client?

a. The CPA firm will provide absolute assurance about whether the financial statements are free of material misstatement.
b. The CPA firm is responsible for ensuring that the client complies with applicable laws.
c. The CPA firm will involve information technology specialists in the performance of the audit.
d. The CPA firm will adjust the financial statements to correct misstatements before issuing a report.

(R/09, AUD, A2728A, #34, 8834)

35. A CPA is engaged to examine an entity's financial forecast. The CPA believes that several significant assumptions do not provide a reasonable basis for the forecast. Under these circumstances, the CPA should issue a(an)

a. Adverse opinion
b. Pro forma opinion
c. Qualified opinion
d. Unqualified opinion with an explanatory paragraph (R/09, AUD, 1592A, #35, 8835)

36. Which of the following represents an inherent limitation of internal controls?
a. Bank reconciliations are **not** performed on a timely basis.
b. The CEO can request a check with **no** purchase order.
c. Customer credit checks are **not** performed.
d. Shipping documents are **not** matched to sales invoices. (R/09, AUD, A2099A, #36, 8836)

37. An auditor's tests of controls for completeness for the revenue cycle usually include determining whether
a. Each receivable is collected subsequent to the year-end.
b. An invoice is prepared for each shipping document.
c. Each invoice is supported by a customer purchase order.
d. Each credit memo is properly approved.
(R/09, AUD, 1449A, #37, 8837)

38. Which of the following prospective financial statements is(are) appropriate for general use?

	Financial forecast	*Financial projection*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

(R/09, AUD, 0045A, #38, 8838)

39. Which of the following procedures most likely would assist an auditor to identify litigation, claims, and assessments?
a. Inspect checks included with the client's cutoff bank statement
b. Obtain a letter of representations from the client's underwriter of securities
c. Apply ratio analysis on the current year's liability accounts
d. Read the file of correspondence from taxing authorities (R/09, AUD, 1869A, #39, 8839)

40. Which of the following is the primary objective of probability proportional to sample (PPS) size?
a. To identify overstatement errors
b. To increase the proportion of smaller-value items in the sample
c. To identify items where controls were **not** properly applied
d. To identify zero and negative balances
(R/09, AUD, A1442A, #40, 8840)

41. When assessing the competence of the internal auditors, an independent CPA should obtain information about the
a. Organizational level to which the internal auditors report
b. Quality of the internal auditors' working paper documentation
c. Policies prohibiting internal auditors from auditing sensitive matters
d. Internal auditors' preliminary assessed level of control risk (R/09, AUD, 1636A, #41, 8841)

42. An auditor is testing the reasonableness of dividend income from investments in publicly-held companies. The auditor most likely would compute the amount that should have been received and recorded by the client by
a. Reading the details of the board of directors' meetings
b. Confirming the details with the investee companies' registrars
c. Electronically accessing the details of dividend records on the Internet
d. Examining the details of the client's most recent cutoff bank statement
(R/09, AUD, 1462A, #42, 8842)

43. Analytical procedures used in the planning phase of an audit should focus on
a. Documenting the risk factors relating to the susceptibility of assets to misappropriation
b. Identifying the internal control activities that could reduce the assessed level of control risk
c. Discovering uncorrected misstatements that should be communicated to the audit committee
d. Enhancing the auditor's understanding of the transactions and events that have occurred since the last audit (R/09, AUD, 2212A, #43, 8843)

44. In auditing an entity's computerized payroll transactions, an auditor would be **least** likely to use test data to test controls concerning
a. Overpayment of employees for hours **not** worked
b. Control and distribution of unclaimed checks
c. Withholding of taxes and Social Security contributions
d. Missing employee identification numbers
(R/09, AUD, 0364A, #44, 8844)

45. Which of the following factors is most relevant when an auditor considers the client's organizational structure in the context of control risk?
a. Management's attitude toward information processing and accounting departments
b. The organization's recruiting and hiring practices
c. Physical proximity of the accounting function to upper management
d. The suitability of the client's lines of reporting
(R/09, AUD, A2774A, #45, 8845)

46. An auditor who uses the work of a specialist may refer to the specialist in the auditor's report if the
a. Auditor believes that the specialist's findings are reasonable in the circumstances.
b. Specialist's findings support the related assertions in the financial statements.
c. Auditor modifies the report because of the difference between the client's and the specialist's valuations of an asset.
d. Specialist's findings provide the auditor with greater assurance of reliability about management's representations.
(R/09, AUD, 0352A, #46, 8846)

47. Which of the following ratios would an engagement partner most likely consider in the overall review stage of an audit?
a. Total liabilities/net sales
b. Accounts receivable/inventory
c. Cost of goods sold/average inventory
d. Current assets/quick assets
(R/09, AUD, 1368A, #47, 8847)

48. In attribute sampling, a 25% change in which of the following factors will have the smallest effect on the size of the sample?
a. Tolerable rate of deviation
b. Number of items in the population
c. Degree of assurance desired
d. Planned assessed level of control risk
(R/09, AUD, 1748A, #48, 8848)

49. Which of the following is a conceptual similarity between generally accepted auditing standards and the attestation standards?
a. Both sets of standards require the CPA to report on the adequacy of disclosure in the financial statements.
b. All of the standards of fieldwork in generally accepted auditing standards are included in the attestation standards.
c. The requirement that the CPA be independent in mental attitude is included in both sets of standards.
d. Both sets of standards are applicable to engagements regarding financial forecasts and projections. (R/09, AUD, 1401A, #49, 8849)

50. What is an auditor's responsibility for supplementary information, such as disclosure of pension information, which is outside the basic financial statements but required by the GASB?
a. The auditor should engage a specialist, such as an actuary, to verify that management's assertions are reasonable.
b. The auditor's only responsibility for supplementary information is to determine that such information has **not** been omitted.
c. The auditor should perform tests of transactions to the supplementary information to verify that it is reasonably comparable to the prior year's information.
d. The auditor should apply certain limited procedures to the supplementary information and report deficiencies in, or omissions of, such information. (R/09, AUD, 1895A, #50, 8850)

Problem 3 SIMULATION (40 to 50 minutes)

Internal Control Matters	Misstatements	Analytics	Communication

You have been asked by the audit partner to draft a letter to the client on internal control related matters. You were informed that the written communication regarding significant deficiencies and material weaknesses identified during an audit of financial statements should include certain statements.

For each of the significant deficiencies and material weaknesses reflected in the table below, select from the list provided the appropriate disposition of each statement in regard to the letter to the client on internal control related matters. Each selection may be used once, more than once, or not at all.

Internal Controls	Related Matters
1. State that the purpose of the audit was to express an opinion on the financial statements, and to express an opinion on the effectiveness of the entity's internal control over financial reporting.	
2. Identify, if applicable, items that are considered to be material weaknesses.	
3. State that the author is not expressing an opinion on the effectiveness of internal control.	
4. Include the definition of the term significant deficiency.	
5. Include the definition of the term material weakness, where relevant.	
6. State that the author is expressing an unqualified opinion on the effectiveness of internal control.	
7. State that the communication is intended solely for management and external parties.	
8. Identify the matters that are considered to be significant deficiencies.	

Selection List:

- Included
- Excluded
- Included, but only with client management's approval
- Communicated orally with no need to document the communication

Internal Control Matters | Misstatements | Analytics | Communication

The year under audit is year 2.

During the audit of accounts payable, you detected misstatements previously undetected by the client. All misstatements were related to year 2. For each of the liability misstatements shown below, select the most appropriate item from the list provided.

- In column B, indicate the audit procedure that was most likely used to detect the misstatement.
- In column C, select the internal control that most likely could prevent or detect this type of misstatement in the future.

Audit procedures and internal controls may be selected once, more than once, or not at all.

	Column B	Column C
Misstatement	**Audit Procedure Used to Detect Misstatement**	**Internal Control That Could Prevent or Detect Misstatement in the Future**
1. An accounts payable clerk misplaces year-end invoices for raw materials that were received on December 21, year 2, and, therefore, liabilities were not recorded.		
2. The company tends to be careless in recording payables in the correct period.		
3. The company has the same person approving pay requests and cutting checks.		
4. The company's receiving department misplaces receiving reports for purchases of raw materials at year-end and, therefore, liabilities were not recorded.		

Column B Selection List

1.	From the January, year 3, cash disbursements journal, select payments and match to corresponding invoices.
2.	Review the cash disbursements journal for the month of December, year 2.
3.	On a surprise basis, review the receiving department's filing system, and test check quantities entered on December, year 2, receiving reports to packing slips.
4.	Identify open purchase orders and vendors' invoices at December 31, year 2, and investigate their disposition.
5.	Request written confirmation from the accounts payable supervisor that all vendor invoices have been recorded in the accounts payable subsidiary ledger.
6.	Investigate unmatched receiving reports dated prior to January 1, year 3.
7.	Compare the balances for selected vendors at the end of year 2 and year 1.
8.	Determine that credit memos received 10 days after the balance sheet date have been recorded in the proper period.
9.	Select an unpaid invoice and ask to be walked through the invoice payment process.

Column C Selection List

1.	The purchasing department supervisor forwards a monthly listing of matched purchase orders and receiving reports to the accounts payable supervisor for comparison to a listing of vouched invoices.
2.	The accounts payable supervisor reviews a monthly listing of open purchase orders and vendors' invoices for follow-up with the receiving department.
3.	Copies of all vendor invoices received during the year are filed in an outside storage facility.
4.	All vendor invoices are reviewed for mathematical accuracy.
5.	On a daily basis, the receiving department independently counts all merchandise received.

6.	All vendor invoices with supporting documentation are canceled when paid.
7.	At the end of each month, the purchasing department confirms terms of delivery with selected vendors.
8.	Accounts payable personnel are assigned different responsibilities each quarter within the department.
9.	A clerk is responsible for matching purchase orders with receiving reports and making certain they are included in the proper month.

Internal Control Matters | Misstatements | Analytics | Communication

The table below presents ratios that the company uses to track its performance. During fieldwork, the auditors determined that the ratios were inaccurate due to significant errors, described below, made by the company in year 2. The company has agreed to make adjusting journal entries for year 2 to correct the errors.

After you have determined the appropriate adjusting journal entry (entries) to correct each error, select the impact, if any, that the adjusting journal entry (entries) would have on the erroneous ratio.

Ratio	**Year 2 Erroneous Ratio**	**Ratio**	**Year 2 Erroneous Ratio**
Inventory turnover	4.38	Return on equity	17.53%

Impact of Adjusting Journal Entries on the Inventory Turnover Ratio	**Company Errors**	**Impact of Adjusting Journal Entries on the Return on Equity Ratio**
	1. Inventory stored at a distribution center on December 31, year 2, was inadvertently omitted during the year 2 physical inventory count, to which the general ledger was adjusted.	
	2. During the physical inventory, the company included inventory that it was holding on consignment.	
	3. The company failed to record the materials in transit accrual for late supplier/ vendor invoices.	
	4. The company declared and paid a cash dividend on December 30, year 2, but failed to record the transaction in year 2.	

Selection List:

- Increases
- Decreases
- No impact

Internal Control Matters | Misstatements | Analytics | Communication

During your audit of Wagner Corp., you uncover paid invoices for material fixed assets. However, the purchase of the assets was charged to expenses. Prepare a memo to the engagement partner raising the possibility that this constitutes either a misstatement arising from fraudulent financial reporting or a misstatement arising from a misappropriation of assets. Recommend the next steps to be taken to determine which, if any, of these forms of fraud may have been committed.

REMINDER: On the actual exam your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.

Research

You and your staff have completed an audit of a nonissuer for the calendar year ended December 31, year 2. The audit report date of the financial statement was March 11, year 3, and on March 26, year 3, the client issued the financial statements.

On April 15, year 3, as you are ascertaining that the workpapers and related audit programs are complete and properly signed off, you notice that the financial statements include a material misstatement subsequent to the issuance of an unqualified report. The misstatement was determined to be the inclusion of material nonexistent sales.

Your audit team issued the financial statements. Information regarding nonexistent sales was not known at the date of the audit report. The auditors find the subsequently discovered information is both reliable and existed at the date of the auditor's report. The team determines that the inclusion of the material nonexistent sales would have affected the audit report. The audit team believes there are persons currently relying on, or likely to rely on, the financial statements. Is the auditor's responsibility with respect to the nonexistent sales different if the auditor has resigned or been discharged prior to undertaking or completing the investigation than if he were the continuing auditor?

Reminder: On the actual exam, you will use an electronic database of authoritative literature to find and select the reference (appropriate section and paragraph of the relevant guidance). Please see the AICPA's tutorial and sample test on their exam Web site (www.cpa-exam.org).

Paragraph reference answer: ____________________ (R/09, AUD, 8942)

Solution 1 MULTIPLE-CHOICE ANSWERS

1. (c) The objective of analytical procedures used in the final review stage of the audit is to assess the conclusions reached and evaluate the overall financial statement presentation. It would generally include *reading the financial statements* and notes *and considering* the adequacy of the evidence gathered in response to unusual or unexpected balances identified and *any unusual or unexpected balances* or relationships *that were not previously identified*. Comparing each individual expense account balance with the relevant budgeted amounts and investigating any significant variations; and calculating each individual expense account balance as a percentage of total entity expenses and comparing the results with industry averages are analytical procedures that would be performed during the course of the audit (used as substantive procedures), not during the final review stage. Analytical procedures are not applicable to tests of controls. (Chapter 24-4-2; 8801; CBT Skill: analysis; CSO: 4.1.0)

2. (b) Inclusion of an entity's compiled financial *projection* in an *offering statement of the entity's initial public offering of common stock* would be *inappropriate* because this is an example of a general use distribution. A financial forecast is the only type of prospective financial statement appropriate for general use. The other three answer alternatives are examples of limited use distributions and could appropriately include either a financial projection or a financial forecast. A financial projection, unlike a financial forecast, is not confined to the presentation of (to the best of the responsible party's knowledge and belief) the expected results. Instead, a projection incorporates one or more hypothetical assumptions. A general use distribution will include parties who will not be able to directly ask the responsible parties questions about the presentation and were not involved in negotiating the terms of the engagement for its preparation. Deprived of this type of involvement, it is best that they receive prospective financial statements that contain only the expected results, i.e., a financial forecast. (Chapter 31-4-2; 8802; CBT Skill: understanding; CSO: 1.1.6)

3. (b) When reviewing the financial statements of a nonpublic entity in accordance with SSARS, the accountant is required to *obtain a management representation letter*. A review differs significantly from an audit of financial statements in which the auditor provides reasonable assurance that the financial statements, taken as a whole, are free of material misstatement. The objective of a review is to express 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 GAAP or OCBOA. A review does not contemplate obtaining an understanding of the entity's internal control, thus assessing control risk is not required. Nor does it involve tests of accounting records by obtaining sufficient, appropriate audit evidence via inspection, observation, confirmation or examination of source documents or other procedures usually performed in an audit, so confirmation of account balances and observation of the physical inventory would also not be required. Chapter 31-1-3; 8803; CBT Skill: analysis; CSO: 3.8.0)

4. (b) Ordinarily, information that significantly contradicts the going concern assumption relates to the entity's inability to continue to meet its obligations (*recurring working capital shortages*) as they become due without substantial disposition of assets outside of the ordinary course of business, restructuring of debt, externally forced revisions of its operations, etc. As this definition indicates, some items (all of the other answer alternatives) are usually a concern only when considered in conjunction with other financial difficulties or negative trends and depending on the circumstances. *Recurring working capital shortages* is a stand-alone indication that there could be a going concern issue, thus it is the best answer. The cash infusion would be a concern if was needed to meet current obligations. Lack of new customers would be a concern if the company needed to maintain a certain rate of growth to meet its current obligations. Term debt refinanced with a new bank would be reviewed by an auditor for other reasons, but on the surface, is not an indicator of a going concern problem. It would be if the refinancing was done under less favorable terms due to working capital shortages. (Chapter 28-9-3; 8804; CBT Skill: judgment; CSO: 4.4.0)

5. (c) The blank form of accounts receivable confirmation does not include the amount or other information; the recipients are requested to provide it. This form may provide a greater degree of assurance about the information confirmed, however it may be less efficient than the other positive form because *more nonresponses to the requests are likely to occur* due to the extra effort required of the recipients. Neither inspection of shipping documents or verification of subsequent cash receipts are dictated by the use of the blank form; however, they may be part of the alternative procedures the auditor uses if the response rate to the confirmation process is too low. That recipients may sign the forms without proper investigation is an issue with the other type of positive confirmation that includes the amounts

and/or other information. Editor note: The blank form is a type of positive confirmation. The question indicates that it is not which may have been why the examiners released this question. They may not intend to use it again for this reason. (Chapter 25-3-2; 8805; CBT Skill: judgment; CSO: 3.1.3)

6. (a) The compilation report should *not include a reference to the original engagement*, any review procedures that may have been performed, or scope limitations that resulted in the changed engagement. A reference to a departure from GAAS is not related to the question because an accountant must perform a compilation or review of a nonpublic entity in accordance with SSARS, not GAAS. (Chapter 31-1-5; 8806; CBT Skill: analysis; CSO: 5.1.2)

7. (d) If *the accounts payable manager issues purchase orders*, incompatible functions of authorization and record keeping are combined creating a weakness in internal control. A person should not be in the position to both perpetrate and conceal errors or fraud in the normal course of their duties, thus the duties of authorization, record keeping, and custody of assets should be separated. The other answer alternatives describe appropriate internal controls. (Chapter 23-5-2; 8807; CBT Skill: analysis; CSO: 2.4.0)

8. (c) A successor auditor's inquiries of the predecessor auditor should include questions regarding *the predecessor's understanding as to the reasons for the change in auditors.* The purpose of the inquiries is to assist the successor auditor in determining whether to accept the engagement. (The other answer alternatives do not directly relate to that.) Other matters subject to inquiry for this purpose are information that might bear on the integrity of management; disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters; communications to those charged with governance regarding fraud and illegal acts by clients; and communications to management and those charged with governance regarding significant deficiencies and material weaknesses in internal control An auditor should not accept an engagement until the appropriate communications with the predecessor auditor have been evaluated. The predecessor's evaluation of audit risk and judgment about materiality would have limited if any value for the current audit; additionally these are matters of judgment that are the sole responsibility of the successor auditor. After the date of the report, an auditor has no obligation to make any further or continuing inquiry or perform any other auditing procedures with respect to the audited financial statements covered by that report, unless new information which may affect the report comes to the auditor's attention. The question did not indicate that was the case, so subsequent events that occurred since the predecessor's audit report was issued would generally not be appropriate subject matter for successor inquiries. The predecessor's knowledge of accounting and auditing matters of continuing significance may be of interest to the successor auditor as revealed by the successor's auditor's review of the predecessor's workpapers for purposes of planning the engagement but not for determining to accept the engagement. (Chapter 21-5-2; 8808; CBT Skill: understanding; CSO: 1.3.0)

9. (d) An auditor would most likely consider the possibility that a client's financial statements contained material misstatements if *the results of an analytical procedure disclosed unexpected differences*. An auditor should evaluate significant unexpected differences. If an explanation for the difference cannot be obtained, the auditor should design further audit procedures to determine whether the difference is a likely misstatement. Whenever an auditor becomes aware that management has consulted with other accountants about significant accounting matters (whether or not this was disclosed to the auditor by management) the auditor should discuss with those charged with governance the auditor's views about those same matters. Whether this would cause the auditor to consider that the financial statements might be materially misstated would depend on the circumstances. The delivery of the management representation letter is an issue that should be explained to the client during the initial stage of the planning stage of the audit and documented in an engagement letter along with other understandings with the client. The representations should be dated as of the date of the auditor's report. (The reference to completion of fieldwork is based on superseded guidance.) At any rate the CFO is not refusing to sign and although such representations are part of the audit evidence, they complement, rather than serve as a substitute for, other audit procedures; thus any issue with them would be less of a concern regarding material misstatements than an unexpected difference disclosed by analytical procedures. Audit trails of computer-generated transactions existing for a short time are not an indication of a material misstatement. The auditor should be aware of the client's record retention policies and either arrange to test the transactions during their existence or develop alternative auditing procedures. (Chapter 24-4-3; 8809; CBT Skill: analysis; CSO: 4.3.0)

10. (a) The auditor's objective when evaluating accounting estimates is to determine if all accounting

estimates that could be material to the financial statements have been developed; *are reasonable in the circumstances;* and are presented in conformity with GAAP and are properly disclosed. The opposite is true of alternatives "b" and "d", i.e., accounting estimates should be used when data concerning past events can**not** be accumulated in a timely, cost-effective manner; and accounting estimates **should** be used when the measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events. Obviously, there is no need to use an estimate for accounts receivable greater than 90 days past due or any other account / amount that can be readily calculated using actual data (Chapter 25-3-10; 8810; CBT Skill: understanding; CSO: 1.11.2)

11. (c) One of the conditions that must be met by a practitioner who accepts an engagement to apply agreed-upon procedures in accordance with SSAE to prospective financial statements is that *the practitioner and specified parties agree upon the procedures to be performed by the practitioner.* The prospective financial statements must include a summary of significant assumptions, not account ting policies. The specified parties, not the practitioner, must take responsibility for the sufficiency of the agreed-upon procedures for their purpose. The practitioner does not report on the criteria to be used in the determination of findings, rather the criteria must be agreed upon between the practitioner and the specified parties. (Chapter 31-4-2; 8811; CBT Skill: understanding; CSO: 3.9.0)

12. (d) This question describes an analytical procedure known as a *reasonable test* which is a comparison of an estimated amount, calculated by the use of relevant financial and nonfinancial information, with a recorded amount. (Chapter 24-4-4 8812; CBT Skill: judgment; CSO: 2.7.0)

13. (c) The analytical procedure that an auditor most likely would perform when planning an audit is *comparing current year balances to budgeted balances*. Recalculating interest expense based on notes payable balances is an analytical procedure, but not one that would generally be performed during the planning phase. Analytical procedures used in planning the audit generally use data aggregated at a high level The other answer alternatives are examples of tests of details, not analytical procedures. (Chapter 24-4-1; 8813; CBT Skill: analysis; CSO: 1.7.0)

14. (a) The auditor should obtain an understanding of the nature of the work performed by a specialist, such as an actuary. This understanding should include the *objectives and scope of the* specialist's [*actuary's*] *work*. The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist, not the auditor. The client is not required to consent to the auditor's use of the actuary's work; the auditor decides if there are matters that require special skill or knowledge and thus require using the work of a specialist to obtain appropriate audit evidence. Naturally, the auditor enjoys greater assurance of reliability if a specialist does not have a relationship with the client, however if the auditor can attain satisfaction that the specialist's objectivity will not be impaired, such a specialist can be acceptable. (Chapter 24-5-3; 8814; CBT Skill: understanding; CSO: 1.10.2)

15. (c) Titles such as balance sheet, statement of financial position, statement of income (or income statement), statement of operations, and statement of cash flows are generally understood to be applicable only to financial statements that are presented in accordance with GAAP. Financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP (OCBOA) should not use these "GAAP" titles. Examples of suitable titles for cash basis financial statements are statement of assets and liabilities arising from cash transactions, or *statement of revenues collected and expenses paid.* (Chapter 30-2-2; 8815; CBT Skill: understanding; CSO: 5.1.10)

16. (b) *The timing of control and substantive tests* could be difficult to determine because electronic evidence may not be retrievable after a specific period if files are changed and if backup files do not exist. The auditor must consider the entity's data retention policies when determining the timing of some procedures. The determination of the other answer alternatives is not made more difficult because electronic evidence may not be retrievable after a specific period. (Chapter 27-2-3; 8816; CBT Skill: judgment; CSO: 1.10.5)

17. (c) One of the purposes of establishing quality control policies and procedures for deciding whether to accept or continue a client relationship is to *minimize the likelihood of associating with clients whose management lacks integrity.* Monitoring the risk factors concerning misstatements arising from the misappropriation of assets is not an aspect of a CPA's firm quality control system. Providing reasonable assurance that personnel are adequately trained to fulfill their responsibilities is part of both the human resources element and the engagement performance element of a quality control system rather than the acceptance and continuance of client

relationships and specific engagements element. Documenting objective criteria for the CPA firm's responses to peer review comments is part of the engagement performance element of a firm's quality control system. (Chapter 21-4-2; 8817; CBT Skill: understanding; CSO: 1.2.3)

18. (c) *Access to blank checks and signature plates is restricted to the cash disbursements bookkeeper who personally reconciles the monthly bank statement* is the situation that most likely could lead to an embezzlement scheme. Bank reconciliations should not be prepared by persons who sign checks or keep the records for receipts or disbursements. This is an example of incompatible functions which place a person in the position to both perpetrate and conceal errors or fraud in the normal course of their duties. The duties of authorization, record keeping, and custody of assets should be separated. Additionally, bank reconciliations should not be done by persons with responsibility for handling cash receipts. The other answer alternatives are examples of appropriate duties / control practices. (Chapter 23-1-2; 8818; CBT Skill: understanding; CSO: 2.2.0)

19. (c) An accountant is not required to be independent to perform a *compilation* engagement. The lack of independence should be specifically disclosed (by adding a statement to the last paragraph of the report) without describing the reason for the lack of independence. Independence is required for the other answer alternatives. (Chapter 31-1-2; 8819; CBT Skill: understanding; CSO: 3.8.0)

20. (d) An accountant's compilation report on a financial forecast should include a caveat that the prospective results may not be achieved, such as *there will usually be differences between the forecasted and actual results* because events and circumstances frequently do not occur as expected, and those differences may be material. Answers "a" and "c" are not correct because the report should also include a statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the prospective financial statements or the assumptions. There is no requirement that the forecast be read in conjunction with the audited historical financial statements. (Chapter 31-4-2; 8820; CBT Skill: understanding; CSO: 5.1.6)

21. (a) When deviations from prescribed controls are discovered the auditor should *make inquiries to understand the potential consequences of the deviation*. The auditor should never assume that a deviation is an isolated occurrence without audit significance. Answer alternatives "c" and "d" may or may not be determined to be appropriate actions after the auditor has gained an understanding of the potential consequences. (Chapter 23-4-3; 8821; CBT Skill: judgment; CSO: 2.6.0)

22. (d) The event that is the least likely indicator of the existence of related party transactions is the writing off obsolete inventory to net realizable value just before year-end. A company should have policies and procedures in place to do this and it would be considered by an auditor searching for related party transactions. The other three answer alternatives are indicators of the existence of related party transactions. (Chapter 24-8-1; 8822; CBT Skill: judgment; CSO: 1.10.4)

23. (a) As part of the process of observing a client's physical inventories, an auditor should be alert to *the inclusion of any obsolete or damaged goods.* The other answer alternatives are auditing considerations for inventories, but they do not directly relate to the observation of the client's physical count of inventory quantities. (Chapter 25-3-3; 8823; CBT Skill: understanding; CSO: 3.1.4)

24. (c) After the date of the report, the auditor has no obligation to make any further inquiry or perform any other auditing procedures concerning audited financial statements, unless new *information that existed at the report date and may affect the report comes to the auditor's attention.* (Chapter 28-7-3; 8824; CBT Skill: understanding; CSO: 5.3.1)

25. (d) *The accountant must be independent to issue the review report* because although the accountant is not expressing an opinion, limited assurance is being given. The other answer alternatives are not true. (Chapter 31-1-3; 8825; CBT Skill: understanding; CSO: 3.8.0)

Solution 2 ADDITIONAL MULTIPLE-CHOICE ANSWERS

26. (a) Materiality limits ordinarily would apply to management representations related to *amounts concerning related party transactions.* Materiality considerations would not apply to those representations that are not directly related to amounts included in the financial statements such as the availability of financial records or the completeness of minutes of directors' meetings. Other items of this nature are management's acknowledgement of its responsibility for the fair presentation of financial statements in conformity with GAAP and communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices. Nor would materiality apply to irregularities involving members of management because of the possible effects of fraud on other aspects of the audit. (Chapter 24-3-3; 8826; CBT Skill: judgment; CSO: 3.5.0)

27. (b) The tolerable rate is the maximum rate of deviation from the prescribed internal control policies and procedures that would support the auditor's assessed level of control risk. In this case, the auditor has assessed control risk too high. The risk of assessing control risk too high is the risk that the assessed level of control risk based on the sample is greater (*the deviation rate in the auditor's sample exceeds the tolerable rate,…*) than the true operating effectiveness of the control (…*but the deviation rate in the population is less than the tolerable rate*). The situation described in answer "a" would result in assessing control risk too low. Answers "c" and "d" would support the auditor's assessment of control risk. (Chapter 26-1-4; 8827; CBT Skill: analysis; CSO: 3.1.1)

28. (b) If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements, taken as whole, the accountant should *withdraw from the* compilation (or review) *engagement and provide no further services concerning those financial statements*. It may also be advisable for the accountant to consult with an attorney. (Chapter 31-1-4 8828; CBT Skill: analysis; CSO: 5.1.2)

29. (b) If *management does not provide reasonable justification for a change in accounting principle*, the auditor should express a qualified opinion or, if the effect of the change is sufficiently material, the auditor should express an adverse opinion. A disclaimer of opinion should not be expressed because there are material departures from GAAP. All of the other answer alternatives are examples of scope limitations. Restrictions on the scope of an audit, whether imposed by the client or by circumstances, may require the auditor to qualify the opinion or to disclaim an opinion. (Chapter 28-4-3; 8829; CBT Skill: analysis; CSO: 5.1.1)

30. (a) The third standard of fieldwork states: "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." (Chapter 24-1-1; 8830; CBT Skill: understanding; CSO: 4.2.0)

31. (a) The purpose of analytics in the planning stage of the audit is to assist in planning the audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions. To accomplish this one of the things the auditor should focus on is the transactions and events that have occurred since the last audit date. The *unaudited information from internal quarterly reports* would be the best source of information for developing expectations. Expectations, in this context, are the auditor's predictions of recorded accounts or ratios. The effectiveness of analytical procedures depends on developing expectations that can reasonably be expected to identify unexpected relationships. Account assertions in the planning memorandum would not provide the needed data to develop such expectations. The auditor is interested in transactions and events that have occurred since the last audit date, so comments in the prior year's management letter would have limited usefulness and again would probably not include data needed to derive expectations. Control risk affects the reliability of data and thus the precision of the expectation, but it would not be considered a source for developing expectations. (Chapter 24-4-1; 8831; CBT Skill: understanding; CSO: 3.1.2)

32. (c) The decision about which procedure to use (analytics or tests of details, or a combination) is based on the auditor's judgment of their effectiveness and efficiency in identifying potential misstatements in the given situation. The effectiveness and efficiency of analytical procedures is based on the nature of the assertion; the plausibility and predictability of the relationship; the availability and *reliability of the data used to develop expectations*; and the *precision* of the expectation. The other answer alternatives are not relevant considerations. (Chapter 24-4-3; 8832; CBT Skill: understanding; CSO: 3.1.2)

33. (d) Inherent risk is *the susceptibility of a* relevant *financial statement assertion to a misstatement* that could be *material*, either individually, or

when aggregated with other misstatements*, assuming that there are no related controls*. If the auditor decides it would be efficient to consider how the internal auditors' work might affect the nature, timing and extent of audit procedures, the auditor should assess the competence and objectivity of the internal auditors. This evaluation affects detection risk, not inherent risk. The risk that the internal control system will not prevent or detect a material misstatement on a timely basis is control risk, not inherent risk. The effectiveness of an audit procedure or its application by the auditor is detection risk, not inherent risk. (Chapter 22-2-4 8833; CBT Skill: judgment; CSO: 1.9.0)

34. (c) The statement most likely to be included in an engagement letter from an auditor to a client is that *the CPA firm will involve information technology specialists in the performance of the audit*. Involvement of specialists or internal auditors, if applicable, is something the auditor may choose to include in the letter. The engagement letter should include a statement that the auditor will obtain reasonable (not absolute) assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud; accordingly a material misstatement may remain undetected. The letter should state that management (not the auditor) is responsible for identifying and ensuring that the entity complies with the laws and regulation applicable to its activities. The letter should also state that management (not the auditor) is responsible for adjusting the financial statement to correct material misstatements. (Chapter 22-1-2; 8834; CBT Skill: judgment; CSO: 1.5.0)

35. (a) If the CPA believes the assumptions do not provide a reasonable basis for the forecast, the CPA should issue an *adverse opinion*. The opinion paragraph should include a statement to that effect. (Chapter 31-4-2; 8835; CBT Skill: understanding; CSO: 5.1.6)

36. (b) One of the inherent limitations of internal control is inappropriate management override of internal control. An example of this would be if *the CEO can request a check with no purchase order.* The other answer alternatives describe weaknesses in internal control, but they are not *inherent* limitations. Inherent limitations are intrinsic—no matter how well designed and operated, internal control can only provide an entity with reasonable, not absolute, assurance. (Chapter 23-2-1; 8836; CBT Skill: judgment; CSO: 2.4.0)

37. (b) When testing for completeness for the revenue cycle, the auditor is checking to see that all sales have been recorded. Tracing ("up the house") from a *shipping document* to an invoice tests that goods that were shipped were also invoiced. The auditor would also need to confirm that the invoice was recorded. Testing receivables to see if they were collected subsequent to the year-end is done to determine if there was proper cutoff. Checking to see that each invoice is supported by a customer purchase order and that credit memos are properly authorized is testing for occurrence (validity). (Chapter 23-5-2; 8837; CBT Skill: analysis; CSO: 2.6.0)

38. (b) A financial *forecast* is the only type of prospective financial statement appropriate for *general use*. *General use* refers to use of the statements by parties who are not negotiating directly with the responsible party. Because recipients of prospective financial statements distributed for general use are unable to ask the responsible party directly about the presentation, the presentation most useful to them is one that portrays, to the best of the responsible party's knowledge and belief, the expected results, i.e., a financial *forecast*. Any type of prospective financial statements that would be useful in the circumstances would normally be appropriate for limited use. Thus, a limited use distribution could include either a financial forecast or a projection. (Chapter 31-4-2; 8838; CBT Skill: understanding; CSO: 1.1.3)

39. (d) Management is the primary source of information about litigation, claims and assessments, however most audits include other procedures (usually for other purposes) that may also assist the auditor in identifying such matters. These include reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited; reading contracts, loan agreements, leases, and *correspondence from taxing* or other governmental *authorities*, and similar documents; obtaining information concerning guarantees from bank confirmation forms, and inspecting other documents for possible guarantees by the client. Answers "a" and "b" could possibly reveal evidence of litigation, claims, and assessments, but correspondence from taxing authorities is a more likely source. Applying ratio analysis on the current year's liability accounts is the least likely procedure of the alternatives to disclose such information. (Chapter 24-6-2; 8839; CBT Skill: analysis; CSO: 3.2.0)

40. (a) In PPS sampling, because the sample is selected proportional to size, larger dollar amounts have a higher probability of being selected, thus *overstatements* (*errors*) are more likely to be selected than understatements. An auditor will normally

use PPS sampling when testing for material overstatements. For the reason just stated, PPS sampling is unlikely to select smaller-value items and these amounts may be significantly understated in the sample, not increased. PPS sampling is a form of variables sampling which is normally used in substantive testing where the auditor is usually interested in the selection of dollar amounts, not attributes as is usually the case in tests of controls. Additionally, samples taken to test the operating effectiveness of controls (to provide a basis for the auditor to conclude whether the controls are being properly applied) should be selected in a manner such that the sample is representative of the population, thus all items in the population should have an opportunity to be selected which is not the case with PPS sampling. Zero balances are not subject to PPS selection and negative balances would have to be segregated into a separate population for testing. (Chapter 26-5-1; 8840; CBT Skill: analysis; CSO: 3.1.1)

41. (b) When assessing the competence of internal auditors, one of the factors a CPA should consider is *the quality of the internal auditors' working paper documentation,* reports, and recommendations*.* The organizational level to which they report is an indicator of their objectivity, not their competence. Alternative "c" is a nonsense answer. Obviously, you would not want to bar internal auditors from auditing sensitive matters. However, a policy prohibiting them from auditing areas where **relatives** are employed in important or audit-sensitive positions is a measure of their objectivity, but again, not their competence. The evaluation of internal auditor's preliminary assessed level of control risk would be an indicator of their competence because monitoring the performance of an entity's controls is one of internal audit's major responsibilities. However, it is more likely that an independent CPA would obtain information about this matter to assess the relevance of internal audit activities. The "best", in this case, the most clear-cut answer, is "b". (Chapter 24-2-2; 8841; CBT Skill: understanding; CSO: 1.10.3)

42. (c) Published dividend records provide the strongest evidence supporting dividends earned on marketable equity securities. (Chapter 25-3-5; 8842; CBT Skill: analysis; CSO: 3.1.5)

43. (d) Analytical procedures used in the planning phase of an audit should focus on *enhancing* the auditor's understanding of the client's business and *the auditor's understanding of the transactions and events that have occurred since the last audit*, and identifying areas that may represent specific risks relevant to the audit. The other answer alternatives do not describe activities that would occur during the planning phase of an audit. (Chapter 24-4-1; 8843; CBT Skill: analysis; CSO: 1.7.0)

44. (b) In auditing an entity's computerized payroll transactions, an auditor would be least likely to use test data to test controls concerning control and distribution of unclaimed checks. The other answer alternatives are examples of data that can be accessed and tested via computer applications while controls over unclaimed checks are more likely to be manual. (Chapter 27-5-2 8844; CBT Skill: analysis; CSO: 3.1.6)

45. (d) Control risk is a function of the effectiveness of the design and operation of internal control in achieving a company's objectives relevant to the preparation of the financial statements. One of the five components of internal control is the control environment. One of the elements of the control environment is a company's organizational structure. As it provides the framework for accomplishing the company's objectives, a relevant organizational structure includes considering key areas of authority and responsibility and appropriate (*suitable*) *lines of reporting*. The key to selecting the best answer was to determine which was most related to a company's organizational structure. Management's attitude and recruiting and hiring practices are not directly related to organizational structure, as is the case with lines of reporting. The physical proximity of the accounting function to upper management could be completely unrelated to organizational structure. (Chapter 23-1-2; 8845; CBT Skill: analysis; CSO: 2.7.0)

46. (c) An auditor who uses the work of a specialist may refer to the specialist in the auditor's report if the *auditor modifies the report because of the difference between the client's and the specialist's valuations of an asset* **and the auditor believes such reference will facilitate the understanding of the reason for the modification**. The modification may take the form of either the addition of an explanatory paragraph to a standard report or the departure from an unqualified opinion. If the auditor believes that the specialist's findings are reasonable in the circumstances, ordinarily the auditor would use the findings, but this does not speak to whether a reference in the auditor's report is appropriate because there is no indication of whether the findings support the related assertions in the financial statements and thus do or do not require modification of the auditor's report. If the specialist's findings support the related assertions in the financial statements or provide the auditor with greater assurance

of reliability about management's representations, it follows that the auditor will be able to conclude that sufficient appropriate audit evidence has been obtained. As no modification of the auditor's report is needed as a result of the specialist's findings, no reference should be made to the specialist because it could be misinterpreted as either a qualification or a division of responsibility. (Editor note: This question is an example of when candidates must choose the best answer. The other answer alternatives are clearly wrong and answer "c" is at least partially correct.) (Chapter 24-5-5; 8846; CBT Skill: analysis; CSO: 1.10.2)

47. (c) An engagement partner would most likely consider *cost of goods sold/average inventory* in the overall review stage of an audit. Known as *inventory turnover,* it measures the number of times inventory is acquired and sold during a period and is thus used as an indicator of the efficiency of the operations of a company. The other answer alternatives are not meaningful financial statement analysis calculations. (Chapter 24-4-2; 8847; CBT Skill: analysis; CSO: 4.1.0)

48. (b) The *number of items in the population* has virtually no effect on the sample size unless the population is very small. (Chapter 26-3-3; 8848; CBT Skill: understanding; CSO: 3.1.1)

49. (c) *The requirement that the CPA be independent in mental attitude is included in both sets of standards*. Only GAAS require the CPA to report on the adequacy of disclosure in the financial statements. The attestation standards do not include a standard similar the GAAS second standard of fieldwork: "The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures." Only the attestation standards are applicable to engagements regarding financial forecasts and projections. (Chapter 31-3-3; 8849; CBT Skill: understanding; CSO: 1.1.3)

50. (d) The auditor has no responsibility to audit information outside the basic financial statements in accordance with GAAS. However, the auditor does have certain responsibilities with respect to it. The nature of this responsibility varies with the nature of the information and the document containing the financial statements. With respect to supplementary information required by the FASB, GASB or FASAB, *the auditor should apply certain limited procedures to it and report deficiencies in, or the omission of, such information*. Required supplementary information differs from other types of information outside the basic financial statements because the FASB, GASB, or FASAB considers the information an essential part of the financial reporting of certain entities and accordingly authoritative guidelines for the measurement and presentation of the information have been established. (Chapter 28-11-2; 8850; CBT Skill: understanding; CSO: 5.1.9)

Solution 3 SIMULATION ANSWER

Response #1: Internal Control Matters (6 points)

Editor note: In October 2008, the AICPA's Accounting Standards Board issued SAS 115, *Communicating Internal Control Related Matters Identified in an Audit.* This statement is effective for audits of financial statements for periods ending on or after December 15, 2009 with earlier implementation permitted. It supersedes SAS 112 of the same title. This new statement was eligible to be tested beginning with the April-May 2009 exam window. Changes in guidance per SAS 115 are indicated (*parenthetically in italics*) in this section with previous guidance ~~struck through~~; however bear in mind that this method of presentation was chosen to better clarify the differences between the two statements because **both the previous and the new statement may be tested** in the April-May, July-August, and October-November 2009 exam windows. Starting with the January-February 2010 exam window only the new statement is testable. Additional coverage of SAS 115 is included in the "Recent Pronouncements" section of this updating supplement.

1. Excluded

The written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should ~~state that the purpose of the audit~~ (*include a statement that indicates the purpose of the auditor's consideration of internal control*) was to express an opinion on the financial statements, **but not** to express an opinion on the effectiveness of the entity's internal control ~~over financial reporting~~.

2. Included

The complete statement is: Identify the matters that are considered to be significant deficiencies and~~, if~~

~~applicable,~~ those that are considered to be material weaknesses.

3. Included

Self-explanatory.

4. Included

The complete statement is: Include the definition of the term~~s~~ ~~*significant deficiency*~~ (material weakness) and, where relevant, (*the definition of the term*) ~~*material weakness*~~ (significant deficiency). *[Editor note: The order of the terms is reversed by SAS 115.]*

5. Included

See the explanation for item 4.

6. Excluded

There should be a statement that the auditor is **not** expressing an opinion on the effectiveness of internal control.

7. Excluded

There should be a statement that the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is **not** intended to be and should **not** be used by anyone other than these specified parties.

8. Included

See the explanation for item 2.

Response #2: Misstatements (6 points)

1. Column B: 6

   A search for unrecorded liabilities would include the investigation of unmatched receiving reports.

   Column C: 1

   The process of comparing the receiving reports to the voucher packages would have revealed the missing invoices.

2. Column B: 1

   A review for proper cutoff of purchases is accomplished by comparing year 3 cash disbursement entries with the dates on the corresponding invoices to see if any invoices received in year 2 were recorded in year 3.

   Column C: 9

   This procedure would help to ensure that the liability was recorded in the month the goods were received.

3. Column B: 9

   A walk-through would allow the auditor to observe that incompatible functions were being performed by the same person.

   Column C: 8

   This procedure is the best choice from the available ones. A better control would simply be not to allow the same person to perform both functions.

4. Column B: 4

   A search for unrecorded liabilities would include the investigation of unmatched invoices.

   Column C: 2

   Following up on unmatched invoices with the receiving department should help to identify unreported received goods.

Response #3: Analytics (6 points)

$$\text{Inventory turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$\text{Return on equity} = \frac{\text{Net Income}}{\text{Average Stockholders' Equity}}$$

1. Dr. Inventory
   Cr. Inventory Over and Short

   To reverse erroneous reduction of inventory; inventory at distribution center should not have been omitted in physical inventory count

   Impact on inventory turnover ratio: Decreases

   This journal entry caused cost of goods sold to decrease by a greater proportion than average inventory increased, so the ratio decreased.

   Impact on return on equity ratio: Increases

   This journal entry caused net income to increase by a greater proportion than average stockholder's equity, so the ratio increased.

2. Dr. Inventory Over and Short
   Cr. Inventory

   To reverse erroneous increase of inventory; consigned goods should not have been included in physical inventory count

   Impact on inventory turnover ratio: Increases

   This journal entry caused cost of goods sold to increase by a greater proportion than average inventory decreased, so the ratio increased.

   Impact on return on equity ratio: Decreases

   This journal entry caused net income to decrease by a greater proportion than average stockholder's equity, so the ratio decreased.

3. Dr. Inventory
   Cr. Accounts Payable

   To adjust for materials in transit not recorded

   Impact on inventory turnover ratio: Decreases

   This journal entry caused cost of goods sold to decrease by a greater proportion than average inventory increased, so the ratio decreased.

   Impact on return on equity ratio: Increases

   This journal entry caused net income to increase by a greater proportion than average stockholder's equity, so the ratio increased.

4. Dr. Retained Earnings
   Cr. Cash

   To record cash dividend paid

   Impact on inventory turnover ratio: No impact

   The payment of the dividend did not affect either component of the ratio.

   Impact on return on equity ratio: Increases

   This journal entry had no effect on net income while it decreased average stockholder's equity, so the ratio increased.

Response #4: Communication (10 points)

To: Engagement Partner

From: Senior Auditor

Re: Audit of Wagner Corporation Financial Statements; Investigation of Material Misstatement Due to Failure to Capitalize Expenditures for Fixed Assets

Our audit has uncovered a material misstatement of the financial statements of Wagner Corporation due to their failure to capitalize expenditures for fixed assets. We discovered invoices documenting purchases of equipment that we have determined were expensed.

Our investigation of this matter is in the initial stages so we have not yet determined whether this misstatement was intentional and thus involves fraud or was unintentional ,i.e., due to an error. We will expand our further audit procedures to make this determination and reevaluate our risk assessment.

We will be alert to both types of fraud: fraudulent financial reporting and the misappropriation of the equipment.

If the equipment can be located we will try to determine through interviews with the persons responsible for recording the purchases why the company's capitalization vs. expense policy was not followed. If our investigation identifies that this is the only issue, it is unlikely this is a case of fraudulent financial reporting because management is under pressure to increase profits. Expensing these items, of course, substantially lowered net income. Nor does the company's tax situation create undue pressure for lowering recorded income. However, we will review the entire process to see if inappropriate management override of reporting controls occurred that has the appearance of fraud. And unless we find that management override was the only factor, we will make suggestions as to how internal controls can be improved to prevent this from happening in the future.

If the equipment cannot be located we will determine if it was returned or destroyed. It may have also been disposed of for appropriate reasons, but in any case, there was a failure to properly record the event. We will investigate why controls failed in the same manner as described in the preceding paragraph. We may decide to examine the company records regarding claims filed with their insurance carrier to see if in conjunction with whatever our investigation reveals, irregularities exist there that support our concerns. This may or may not lead to the need to confirm issues directly with their insurance carrier.

If the absence of the equipment cannot be explained, we will try to determine if there was any collusion between the vendors' employees and Wagner employees in order to determine the nature of the theft. This may inform our investigation by revealing whether it was a "paper" theft involving only funds or if the equipment was actually stolen. We will seek to confirm that the invoices are valid by contacting the vendors. This will, of course, necessitate gaining beforehand as much assurance as possible under the circumstances that we are not communicating with a vendor employee who could have been involved in the possible fraudulent scheme. If we determine that any of the vendors are related parties we will scrutinize those transactions first. We will examine the canceled checks that were written for all the purchases of the expensed equipment and follow up on any irregularities or patterns we may discover. We will send copies of the cancelled checks to the vendors and ask them to verify that the bank stamps are appropriate and the endorsements are both appropriate and authentic.

We will attempt to walk-through the entire purchase process of the missing equipment. The identification and interviewing of these individuals may reveal a pattern that indicates there was collusion among Wagner employees.

We will seek to authenticate any other documents we are able to locate in the audit trail as well by examining signatures; reviewing the sequence of any date stamps; looking for alterations or missing information; matching with other documents we may have been able to authenticate, etc.

If we find evidence that the goods were received—are able to authenticate and match receiving reports to the invoices—we will interview the employees that signed the receiving reports. We will then try to find records that will allow us to trace the disposition of the equipment after it left the receiving department. If we find proof that procedures were followed and the equipment was placed in storage we will determine if there are records of who had access to the equipment. Additionally, we will examine the physical and procedural security for the stored equipment. This may indicate whether outsiders could have stolen the equipment or if it was more likely to have been an employee,

We will interview other members of management and other appropriate employees not involved in purchasing to determine if they suspect fraud. We will also discuss our concerns with their internal auditors for the same purpose.

I will keep you apprised of our progress and would like to meet with you as soon as possible concerning our formal communications with management and those charged with governance about this matter.

Response #5: Research (2 points)

Paragraph Reference Answer: AU 9561.02

"Interpretation—No. Section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,* requires the auditor to undertake to determine whether the information is reliable and whether the facts existed at the date of his report. This undertaking must be performed even when the auditor has resigned or been discharged."
