1. The communication of reportable conditions about a client's internal control should be addressed only to senior management of the company.
   A) True
   B) False

2. Which of the following procedures is not a required planning procedure for a new client previously audited by another auditor?
   A) Obtaining an understanding of internal control to plan audit procedures.
   B) Obtaining a written "engagement letter" from the client.
   C) Performing analytical procedures.
   D) Attempting communication with the predecessor auditor.

3. Which of the following is an example of fraudulent financial reporting?
   A) An employee "borrows" tools from the company and neglects to return them; the cost is reported as a miscellaneous operating expense.
   B) Company management falsifies inventory count tags thereby overstating ending inventory and understating cost of goods sold.
   C) An employee diverts customer payments to his personal use, concealing his actions by debiting an expense account, thus overstating expenses.
   D) An employee steals inventor and the "shrinkage" is recorded in cost of goods sold.

4. Which of the following is not an example of a likely adjustment in the auditors' overall audit approach when significant risk is found to exist?
   A) Increase the assessed level of detection risk.
   B) Obtain increased evidence about the appropriateness of management's selection of accounting principles.
   C) Apply increased professional skepticism about material transactions.
   D) Assign personnel with particular skill to areas of high risk.

5. CPA firms may use written narratives to describe internal control in their audit working papers.
   A) True
   B) False

6. When performing a financial statement audit, auditors are required to explicitly assess the risk of material misstatement due to:
   A) Errors.
   B) Illegal Acts.
   C) Business risk.
   D) Fraud.

7. Confirming a bank account establishes existence but not rights to the cash balance.
   A) True
   B) False
8. When inherent risk of an account is high, the auditors may perform additional substantive tests to allow them to restrict detection risk to a lower level.
   A) True
   B) False

9. Preliminary arrangements agreed to by the auditors and the client should be reduced to writing by the auditors. The best place to set forth these arrangements is in:
   A) An engagement letter.
   B) A client representation letter.
   C) A confirmation letter attached to the constructive services letter.
   D) A memorandum to be placed in the permanent section of the auditing working papers.

10. To be competent, evidence must be reliable and sufficient.
    A) True
    B) False

11. After obtaining an understanding of internal control and arriving at a planned assessed level of control risk, an auditor decided to perform tests of controls. The auditor most likely decided that:
   A) There were many internal control deficiencies that would allow misstatements to enter the accounting system.
   B) It would be efficient to perform tests of controls that would result in a reduction in planned substantive tests.
   C) Additional evidence to support a reduction in the assessed level of control risk is not available.
   D) An increase in the assessed level of control risk is justified for certain financial statement assertions.

12. Which of the following ultimately determines the specific audit procedures necessary to provide independent auditors with a reasonable basis for the expression of an opinion?
   A) The auditors' working papers.
   B) Generally accepted auditing standards.
   C) The audit program.
   D) The auditors' judgment.

13. A client's internal control appears strong, but the CPA has chosen not to test it. The planned assessed level of control risk is at what level?
   A) Moderate.
   B) Maximum.
   C) Low.
   D) Zero.

14. Although the quantity, type, and content of working papers will vary with the circumstances, the working papers generally would include the:
   A) Auditor's comments concerning the efficiency and competence of client management personnel.
   B) Auditing procedures followed and the testing performed in obtaining evidential matter.
   C) Evaluation of the efficiency and competence of the audit staff assistants by the partner responsible for the audit.
   D) Copies of those client records examined by the auditor during the course of the engagement.
15. Internal auditors should preferably report to the chief accounting officer of the company.
   A) True
   B) False

16. Tests for unrecorded assets typically involve tracing from:
   A) Recorded journal entries to documents.
   B) Source documents to recorded journal entries.
   C) Recorded journal entries to observations.
   D) Source documents to observations.

17. During financial statement audits, auditors seek to restrict which type of risk?
   A) Inherent risk.
   B) Control risk.
   C) Account risk.
   D) Detection risk.

18. The primary purpose of a letter of representations is to obtain additional evidence about specific accounts.
   A) True
   B) False

19. Which of the following is an advantage of describing internal control through the use of a standardized questionnaire?
   A) Questionnaires usually identify situations in which internal control weaknesses are compensated for by other strengths in the system.
   B) Questionnaires highlight weaknesses in the system.
   C) Questionnaires provide a clearer and more specific portrayal of a client's system than other methods of describing internal control.
   D) Questionnaires are more flexible than other methods of describing internal control.

20. The auditors must consider materiality in planning an audit engagement. Materiality for planning purposes is:
   A) The auditors' preliminary estimate of the amount of misstatement that would be material to the client's balance sheet.
   B) The auditors' preliminary estimate of the largest amount of misstatement that would be material to any one of the client's financial statements.
   C) An amount that cannot be quantitatively stated since it depends on the nature of the item.
   D) The auditors' preliminary estimate of the smallest amount of misstatement that would be material to any one of the client's financial statements.

21. Audits of financial statements are designed to obtain reasonable assurance of detecting material misstatements due to:
   A) Errors: Yes; Fraudulent financial reporting: No; Misappropriation of assets: Yes
   B) Errors: Yes; Fraudulent financial reporting: Yes; Misappropriation of assets: Yes
   C) Errors: Yes; Fraudulent financial reporting: Yes; Misappropriation of assets: No
   D) Errors: Yes; Fraudulent financial reporting: No; Misappropriation of assets: No
22. Which of the following is **not** a required source of information for the auditors' assessment of fraud risk?
   A) Results of tests of controls.
   B) Discussion among audit team members.
   C) Inquiry of management and others.
   D) Fraud risk factors.

23. Which of the following is most likely to be considered a risk factor relating to fraudulent financial reporting?
   A) Sales goals in excess of any of the preceding three years.
   B) Low turnover of senior management.
   C) Extreme degree of competition within the industry.
   D) Capital structure including various operating subsidiaries.

24. Individuals who commit fraud are ordinarily able to rationalize the act and also have an:
   A) Incentive: No; Opportunity: No
   B) Incentive: No; Opportunity: Yes
   C) Incentive: Yes; Opportunity: Yes
   D) Incentive: Yes; Opportunity: No

25. Which of the following is **not** a basic approach often used by auditors to evaluate the reasonableness of accounting estimates?
   A) Review of subsequent events.
   B) Independent development of an estimate.
   C) Confirmation of amounts.
   D) Review of management's process of development.

26. Which of the following is **least** likely to be required on an audit?
   A) Test appropriateness of journal entries and adjustments.
   B) Review accounting estimates for biases.
   C) Evaluate the business rationale for significant, unusual transactions.
   D) Make a legal determination of whether fraud has occurred.

27. Vouching the acquisition of assets is an audit procedure that is often performed to establish the valuation of the assets.
   A) True
   B) False

28. Which of the following expressions is **least** likely to be included in a client's representation letter?
   A) The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
   B) Management has made available all financial statements, including notes.
   C) No events have occurred subsequent to the balance sheet date that require adjustment to, or disclosure in, the financial statements.
   D) Management acknowledges responsibility for illegal actions committed by employees.
29. A schedule set up to combine similar general ledger accounts, the total of which appears on the working trial balance as a single amount, is referred to as a:
   A) Lead schedule.
   B) Reconciling schedule.
   C) Supporting schedule.
   D) Corroborating schedule.

30. Which statement is correct relating to a potential successor auditor's responsibility for communicating with the predecessor auditors in connection with a prospective new audit client?
   A) The successor auditors should obtain permission from the prospective client to contact the predecessor auditors.
   B) The successor auditors need not contact the predecessors if the successors are aware of all available relevant facts.
   C) The successor auditors have no responsibility to contact the predecessor auditors.
   D) The successor auditors should contact the predecessors regardless of whether the prospective client authorizes contact.

31. Hawkins requested permission to communicate with the predecessor auditor and review certain portions of the predecessor auditor's working papers. The prospective client's refusal to permit this will bear directly on Hawkins' decision concerning the:
   A) Ability to establish consistency in application of accounting principles between years.
   B) Integrity of management.
   C) Adequacy of the preplanned audit program.
   D) Apparent scope limitation.

32. Which of the following best describes the reason that auditors are concerned with the detection of related party transactions?
   A) The substance of related party transactions will differ from their form.
   B) In a related party transaction one party has the ability to exercise significant influence over the other party.
   C) Material related party transactions must be disclosed in the notes to the financial statements.
   D) The financial statements must often be adjusted for the effects of material related party transactions.

33. Under which circumstance is it likely that the extent of substantive procedures will be expanded beyond that anticipated in the audit plan?
   A) Deviation rates were greater than zero and approached anticipated levels.
   B) The operating effectiveness of certain controls was found to be less than expected, although no material misstatements were identified.
   C) Certain controls do not leave a trail of documentary evidence.
   D) The auditors have determined that controls have been placed in operation but, in accordance with the audit plan, have performed no tests of controls.

34. An auditor selects a sample from the file of shipping documents to determine whether invoices were prepared. This test is performed to satisfy the audit objective of:
   A) Control.
   B) Accuracy.
   C) Existence.
   D) Completeness.
35. For good internal control, which of the following functions should not be assigned to the company's accounting department?
   A) Signing payroll checks.
   B) Reconciling accounting records with existing assets.
   C) Preparing financial reports.
   D) Recording financial transactions.

36. Failure to detect material dollar errors in the financial statements is a risk which the auditors primarily mitigate by:
   A) Assessing control risk.
   B) Performing substantive tests.
   C) Obtaining a client representation letter.
   D) Performing tests of controls.

37. If the auditors' assessment of the design of internal control reveals that it cannot be relied upon, the auditors are not required to prepare any documentation of internal control for their working papers.
   A) True
   B) False

38. Which of the following statements is correct concerning the auditors' understanding of internal control needed by auditors to plan the audit?
   A) The auditors must understand the control environment, risk assessment, and all control activities.
   B) The auditors must understand the information system, not the accounting system.
   C) The auditors must understand monitoring and all preliminary accounting controls.
   D) The auditors must understand the control environment, the information system, and must use judgment as to the control activities which must be considered.

39. The completeness of recording of assets is generally verified by tracing from the source documents to the recorded entry.
   A) True
   B) False

40. Which of the following is not an assertion that is made in the financial statements by management concerning each major account and class of transaction?
   A) Legality.
   B) Completeness.
   C) Presentation and disclosure.
   D) Rights and obligations.

41. The auditors' tests of controls are designed to substantiate the fairness of specific financial statement items.
   A) True
   B) False

42. Which of the following is required documentation in an audit?
   A) A memo setting forth the scope of the audit.
   B) A written engagement letter formalizing the level of services to be provided.
   C) A flowchart of the client's organization.
   D) A written audit program.
43. Which of the following is **not** considered to be an analytical procedure?
   A) Comparisons of financial statement amounts with comparable prior year amounts.
   B) Comparisons of financial statement amounts with source documents.
   C) Comparisons of financial statement amounts with nonfinancial data.
   D) Comparisons of financial statement amounts with budgeted amounts.

44. The auditors are planning an audit engagement for a new client in a business that is unfamiliar to the auditors. Which of the following would be the most useful source of information for the auditors during the preliminary planning stage when they are trying to obtain a general understanding of audit problems that might be encountered?
   A) Latest annual and interim financial statements issued by the client.
   B) Client manuals of accounts and charts of accounts.
   C) AICPA Industry Audit Guides.
   D) Prior-year working papers of the predecessor auditors.

45. When a company has changed auditors, according to the Professional Standards:
   A) The successor may choose not to attempt any communication with the predecessor auditor.
   B) The successor auditor has the responsibility to initiate contact with the predecessor auditor to ask about the client before the engagement is accepted; the predecessor has no responsibility to initiate this contact, even when aware of matters bearing on the integrity of management.
   C) The predecessor must respond fully to all inquiries made by the successor auditor.
   D) The successor must discuss with the predecessor matters bearing on the engagement prior to accepting the engagement.

46. Which of the following would be **least** likely to be regarded as a test of a control?
   A) Tests of signatures on purchase orders.
   B) Recalculation of payroll deductions.
   C) Tests of the signatures on cancelled checks to the authorized check signer list.
   D) Tests of the additions to property by physical inspection.

47. Which of the following factors most likely would cause a CPA to **not** accept a new audit engagement?
   A) The prospective client is unwilling to make financial records available to the CPA.
   B) The prospective client has fired its prior auditor.
   C) The CPA lacks a thorough understanding of the prospective client's operations and industry.
   D) The CPA is unable to review the predecessor auditor's working papers.

48. An abnormal fluctuation in gross profit that might suggest the need for extended audit procedures for sales and inventories would most likely be identified in the planning phase of the audit by the use of:
   A) Specialized audit programs.
   B) Analytical procedures.
   C) An assessment of internal control.
   D) Tests of transactions and balances.
49. Analytical procedures are required at the planning stage of all audits and as:
   A) Substantive tests.
   B) Computer generated procedures.
   C) Tests of internal control.
   D) A part of the final overall review.

50. The risk that the auditors' procedures will lead them to conclude that a material misstatement
does not exist in an account balance when in fact such a misstatement does exist is referred to
as:
   A) Control risk.
   B) Detection risk.
   C) Inherent risk.
   D) Account risk.
Answer Key  (4 points each  = 200 total points)

1. B
2. B
3. B
4. A
5. A
6. D
7. B
8. A
9. A
10. B
11. B
12. D
13. B
14. B
15. B
16. B
17. D
18. B
19. B
20. D
21. B
22. A
23. C
24. C
25. C
26. D
27. A
28. D
29. A
30. A
31. B
32. C
33. B
34. D
35. A
36. B
37. B
38. D
39. A
40. A
41. B
42. D
43. B
44. D
45. B
46. D
47. A
48. B
49. D
50. B
51. One of the five major components of internal control is the control environment. What are five factors that the auditor considers in evaluating the control environment of a client.

(3 points each, maximum 15 total points)

- Integrity and ethical values
- Commitment to competence
- Human resources policies and practices
- Assignment of authority and responsibility
- Management’s philosophy and operating style
- Board of directors or audit committee participation
- Organizational structure

52. List and explain the three components of Audit Risk.

(5 points for each Risk name (bold) and 5 points for each explanation = 30 total points)

- **Inherent Risk**—Risk of a material misstatement occurring in an assertion assuming no related internal controls.

- **Control Risk**—Risk that a material misstatement in an assertion will not be prevented or detected on a timely basis by the company’s internal control.

- **Detection Risk**—Risk that the auditors’ procedures will lead them to conclude that a material misstatement does not exist in an assertion when in fact such misstatement does exist.

53. Auditors are required to obtain and document their understanding of Internal Control to plan the audit. Identify four ways the auditor uses this knowledge to plan the audit.

(4 points each = 16 total points)

- Identify types of potential misstatements
- Consider factors that affect the risk of material misstatement
- Design tests of controls, when applicable
- Design substantive tests

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