1. Which of the following is \textit{not} a function of working papers?
A) Aid partners in planning and conducting future audits.
B) Provide support for the auditors' report.
C) Document staff compliance with generally accepted auditing standards.
D) Provide support for the accounting records.

2. 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) It would be efficient to perform tests of controls that would result in a reduction in planned substantive tests.
B) There were many internal control deficiencies that would allow misstatements to enter the accounting system.
C) An increase in the assessed level of control risk is justified for certain financial statement assertions.
D) Additional evidence to support a reduction in the assessed level of control risk is not available.

3. 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.

4. The auditor faces a risk that the audit will not detect material misstatements in the financial statements. In regard to minimizing this risk, the auditor primarily relies on:
A) Tests of controls.
B) Statistical analysis.
C) Substantive tests.
D) Internal control.

5. Which of the following is \textit{not} ordinarily a procedure for documenting an auditor's understanding of internal control for planning purposes?
A) Confirmation.
B) Questionnaire.
C) Checklist.
D) Flowchart.
6. Which of the following is least likely to be considered a financial statement audit risk factor?
   A) Profitability of the entity relative to its industry is inconsistent.
   B) Rate of change in the entity's industry is rapid.
   C) Management operating and financing decisions are dominated by top management.
   D) A new client with no prior audit history.

7. 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.

8. 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.

9. Which of the following is not one of the assertions made in financial statements by management concerning each major account and class of transactions?
   A) Presentation and disclosure.
   B) Relevance.
   C) Existence.
   D) Valuation.

10. The auditors of Smith Electronics wish to limit the audit risk of material misstatement in the test of accounts receivable to 5 percent. They believe that inherent risk is 100%, and there is a 40% risk that material misstatement could have bypassed the client's system of internal control. What is the maximum detection risk the auditors should specify in their substantive tests of details of accounts receivable?
    A) 12.5%.
    B) 60%.
    C) 5%.
    D) 42.7%.
11. Which of the following statements relating to the competence of evidential matter is always true?
   A) Accounting data developed under satisfactory conditions of internal control are more relevant than data developed under unsatisfactory internal control conditions.
   B) Oral representations made by management are not valid evidence.
   C) Evidence gathered by auditors must be both valid and relevant to be considered competent.
   D) Evidential matter gathered by an auditor from outside an enterprise is reliable.

12. Which of the following procedures is not performed as a part of planning an audit engagement?
   A) Confirmation of all major accounts.
   B) Reviewing the working papers of the prior year.
   C) Designing an audit program.
   D) Performing analytical procedures.

13. The risk of a material misstatement occurring in an account, assuming an absence of internal control, is referred to as:
   A) Control risk.
   B) Detection risk.
   C) Inherent risk.
   D) Account risk.

14. Determining that receivables are presented at net-realizable value is most directly related to which management assertion?
   A) Valuation or allocation.
   B) Presentation and disclosure.
   C) Rights.
   D) Existence or occurrence.

15. Which of the following is true about analytical procedures?
   A) Analytical procedures are tests of controls used to evaluate the quality of a client's internal control structure.
   B) Analytical procedures are used for planning, but they should not be used to obtain evidence as to the reasonableness of specific account balances.
   C) Analytical procedures are used in planning, as a substantive test of specific accounts, and in the final review of the audited financial statements.
   D) Performing analytical procedures results in the most reliable form of evidence.

16. 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) Generally accepted auditing standards.
   B) The auditors' working papers.
   C) The auditors' judgment.
   D) The audit program.
17. To best test existence, an auditor would sample from the:
A) Source documents to the general ledger.
B) General Ledger to source documents.
C) Source documents to journals.
D) General Ledger to the financial statements.

18. Which of the following topics is not normally included in an engagement letter?
A) A description of responsibility for the detection of fraud.
B) Limitations on the scope of the engagement.
C) The auditors' preliminary assessment of internal control.
D) The auditors' estimate of the fee for the engagement.

19. Which of the following is not considered one of the five major components of internal control?
A) Control activities.
B) Risk assessment.
C) Monitoring.
D) Segregation of duties.

20. Which of the following statements is generally correct about the competence of evidential matter?
A) Competence of evidential matter refers to the amount of corroborative evidence to be obtained.
B) Accounting data alone may be considered sufficient competent evidential matter to issue an unqualified opinion on financial statements.
C) The auditor's direct personal knowledge, obtained through observation and inspection, is more persuasive than information obtained indirectly from independent outside sources.
D) To be competent, evidential matter must be either valid or relevant, but need not be both.

21. When a company has changed auditors, according to the Professional Standards:
A) The successor must discuss with the predecessor matters bearing on the engagement prior to accepting the engagement.
B) The successor may choose not to attempt any communication with the predecessor auditor.
C) The predecessor must respond fully to all inquiries made by the successor auditor.
D) 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.

22. Which of the following would be of least interest to the auditors in considering internal control?
A) Policies concerning the reconciliation of accounting records to existing assets.
B) Procedures related to recording transactions.
C) Procedures that are concerned with the decision processes leading to management's authorization of transactions.
D) Procedures restricting access to assets.
23. Which of the following is correct concerning requirements about auditor communications about fraud?
A) The auditor has no responsibility to disclose fraud outside the entity under any circumstances.
B) Fraud that involves senior management should be reported directly to the audit committee regardless of the amount involved.
C) All fraud with a material effect on the financial statements should be reported directly by the auditor to the Securities and Exchange Commission.
D) Fraud with a material effect on the financial statements should ordinarily be disclosed by the auditor through use of an "emphasis of a matter" paragraph added to the audit report.

24. The Sarbanes-Oxley Act of 2002 requires that the audit committee:
A) Be directly responsible for the appointment, compensation and oversight of the work of the CPA firm.
B) Require that the company's CPA firm rotate the partner in charge of the audit.
C) Review the level of management compensation.
D) Annually reassess control risk using information from the CPA firm.

25. ABC Company is audited by the Phoenix office of Willingham CPAs. Which of the following individuals would be least likely to be considered a “covered member” by the independence standard?
A) Staff assistant on the audit.
B) An audit partner in the Eloi office.
C) A tax partner in Phoenix who performs no attest services for ABC Company or for any other clients.
D) The partner in charge of Willingham CPAs (she does no work on the ABC Company Audit).

26. Auditors are periodically punished for holding an investment in a client. This violates which ethical rule?
A) Integrity.
B) Independence.
C) Non compliance with GAAP.
D) Confidentiality.
Essay Questions:

1. After documenting an understanding of internal control the auditor determines a planned assessed level of control risk for the various financial statement assertions. Describe three (3) circumstances in which additional test of controls will not be performed.

2. Identify four risks that may affect an entity's ability to properly record financial data.

3. Identify three fraud risk factors and three procedures the auditor would perform to identify fraud risks.
4. Auditors perform audit procedures to obtain audit evidence that will allow them to draw reasonable conclusions on whether the client’s financial statements follow GAAP. Describe four ways the auditors address the risk of material misstatement.

5. Define inherent risk. Can the auditors reduce inherent risk by performing audit procedures?
Answer Key (5 points each = 130 points) Version 1

1. D
2. A
3. B
4. C
5. A
6. C
7. D
8. C
9. B
10. A
11. C
12. A
13. C
14. A
15. C
16. C
17. B
18. C
19. D
20. C
21. D
22. C
23. B
24. A
25. B
26. B
Essay Questions:

1. After documenting an understanding of internal control the auditor determines a planned assessed level of control risk for the various financial statement assertions. Describe three (3) circumstances in which additional test of controls will not be performed.

   1. Controls are believed to be ineffective, and therefore control risk is to be assessed at the maximum level. (7 points)
   2. Controls are believed to be effective, but testing them is not cost efficient and therefore control risk is to be assessed at the maximum level. (7 points)
   3. Controls are believed to be effective and evidence already obtained is adequate to support a planned assessed level of control risk that is below the maximum level. (7 points)

   (21 points)

2. Identify four risks that may affect an entity’s ability to properly record financial data.

   1. Changes in operating environment (competition) (8 points)
   2. New personnel
   3. New information system
   4. Rapid growth
   5. New technology
   6. New lines, products, or activities
   7. Corporate restructuring
   8. Foreign operations
   9. Accounting pronouncements

   (Maximum points = 32)

3. Identify three fraud risk factors and three procedures the auditor would perform to identify fraud risks.

   Three risk factors:
   1. presence of incentives or pressures (8 points)
   2. opportunity to commit the fraud
   3. attitude to rationalize the act

   Three procedures to identify risk factors:
   1. Discussion among engagement personnel
   2. Making inquiries of client personnel
   3. Performing analytical procedures

   (Maximum = 48 points)
4. Auditors perform audit procedures to obtain audit evidence that will allow them to draw reasonable conclusions on whether the client’s financial statements follow GAAP. Describe four ways the auditors address the risk of material misstatement.

1. Obtain an understanding of the client and its environment to assess the risks of material misstatement.
2. Obtain an understanding of the clients’ internal control.
3. Design and perform tests of controls.
4. Design and perform substantive procedures to test assertions or detect material misstatements.

(7 points for each correct answer. Maximum = 28 points)

5. Define inherent risk. Can the auditors reduce inherent risk by performing audit procedures?

5-2
- Inherent risk refers to the possibility of a material misstatement occurring in an assertion assuming no related internal controls. (8 points)
- Accordingly, since it exists independently of the auditor, auditors cannot "reduce" inherent risk. Rather, they gather evidence that allows them to make an accurate assessment of the existing inherent risk (16 points)
Answer Key Version 2

1. B
2. C
3. B
4. A
5. D
6. B
7. D
8. B
9. A
10. B
11. D
12. C
13. C
14. D
15. C
16. B
17. D
18. D
19. B
20. B
21. D
22. B
23. D
24. B
25. B
26. B