



Following are multiple choice questions recently released by the AICPA. These questions were released by the AICPA with letter answers only. Our editorial board has provided the accompanying explanations.

Please note that the AICPA generally releases questions that it does NOT intend to use again. These questions and content may or may not be representative of questions you may see on any upcoming exams.

1. (Adapted)

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.

ANSWER:

Choice "d" is correct. The auditor's allowable risk of assessing control risk too low has an inverse relationship with sample size when planning a sample for a test of controls.

Choice "a" is incorrect. Preliminary judgments about materiality levels might be a consideration in planning an auditor's sample for a substantive test, but not for a test of controls.

Choice "b" is incorrect. The auditor's allowable risk of assessing control risk too high is not a factor when planning a sample for a test of controls.

Choice "c" is incorrect. The auditor's desired level of detection risk might be a consideration in planning an auditor's sample for a substantive test, but not for a test of controls.

2.

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.

ANSWER:

Choice "a" is correct. Reports on internal control placed in operation and its operating effectiveness produced by the agent's own auditor would be an efficient means of obtaining information about the transfer agent's internal controls.

Choice "b" is incorrect. Whether or not the number of transactions processed by the agent has materially increased (or decreased) is not relevant to obtaining information about the transfer agent's internal controls.

Choice "c" is incorrect. Although performing an audit on the internal control function of the transfer agent would provide information about the transfer agent's internal controls, this would not be as efficient as reviewing the reports from the agent's own auditor.

Choice "d" is incorrect. Performing tests of controls on a sample of the audited firm's transactions through the transfer agent would provide some information about the transfer agent's internal controls, but this would not be as efficient as reviewing the reports from the agent's own auditor.

3.

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.

ANSWER:

Choice "d" is correct. Analytical procedures involve comparison of both financial and relevant nonfinancial information.

Choice "a" is incorrect. Inquiry and analytical procedures are the primary means of evaluating financial statement transactions and balances in a review engagement.

Choice "b" is incorrect. Analytical procedures involve comparisons of recorded amounts to expectations developed based on plausible relationships.

Choice "c" is incorrect. Inquiry and analytical procedures are the primary means of evaluating financial statement transactions and balances in a review engagement, but there is no requirement that they also be used as a final review at the end of the engagement. Note that in an audit, there is such a requirement.

4.

In reviewing the financial statements of a nonissuer, an accountant is required to modify the standard review report for which of the following matters?

	<i>Inability to assess the risk of material <u>misstatement due to fraud</u></i>	<i>Discovery of significant deficiencies in the design of the <u>entity's internal control</u></i>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

ANSWER:

Choice "d" is correct. Neither an understanding of internal control nor an assessment of fraud risk is required in a review of the financial statements of a nonissuer. In addition, the auditor's inability to perform required procedures prevents the issuance of a review report, rather than resulting in modification of the report.

Choices "a", "b", and "c" are incorrect, based on the above explanation.

5.

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.

ANSWER:

Choice "b" is correct. Shipping documents provide evidence that a sale occurred, and tracing from shipping documents to sales invoices might identify instances in which a sale occurred but the associated invoice was not prepared (i.e., if no related invoice can be found).

Choice "a" is incorrect. Selecting a sample of transactions from the cash receipts file is not an appropriate means of identifying sales for which no invoice was prepared, since it will only include sales for which payment has been received. If an invoice was not prepared and mailed, it is unlikely that the customer will have made such a payment.

Choice "c" is incorrect. Selecting a sample of transactions from the customer order might result in items being selected which are not valid sales, for example, if the order has not yet been filled.

Choice "d" is incorrect. Selecting a sample of transactions from the sales invoice file will prevent the auditor from ever identifying sales for which no invoice exists, since there would be no invoice to select in such cases.

6.

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.

ANSWER:

Choice "d" is correct. If the client refuses to accept the CPA's suggestions, the CPA should add a paragraph modifying the disclaimer to describe, in a separate explanatory paragraph, the nature and effect of the departure from GAAP.

Choice "a" is incorrect. If the CPA issues a disclaimer of opinion, no assurance (not even limited assurance) is expressed with respect to the financial statements.

Choice "b" is incorrect. If the client refuses to accept the CPA's suggestions, the CPA should modify the disclaimer to describe the situation, but would not be required to restrict the use of the report.

Choice "c" is incorrect. If the CPA issues a disclaimer of opinion, no assurance is expressed and no opinion is rendered. A qualified or adverse opinion provides a level of assurance beyond that contemplated by a disclaimer.

7.

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.

ANSWER:

Choice "d" is correct. The auditor may choose to perform detailed audit work during an interim period prior to the balance sheet date, especially for accounts that are reasonably predictable. If travel and entertainment expenses are budgeted and closely monitored, they may very well be predictable and subject to interim testing.

Choice "a" is incorrect. Subsequent events occur (by definition) after the balance sheet date, so it would not be possible to review them prior to the balance sheet date.

Choice "b" is incorrect. The search for unrecorded liabilities is a search for obligations that existed, but were not recorded, as of the balance sheet date. Therefore, it would not be possible to perform this search prior to the balance sheet date.

Choice "c" is incorrect. A letter of audit inquiry to the client's legal counsel relates to pending or threatened litigation matters that existed at the balance sheet date and for a period thereafter. Since the letter includes discussion of matters existing at the balance sheet date, it would not be possible to send this letter prior to the balance sheet date.

8.

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.

ANSWER:

Choice "b" is correct. Although it is helpful when the auditor can review client procedures manuals and organizational flowcharts, not having this documentation simply means that the auditor will need to put forth more effort to obtain an understanding of internal control. As is always the case, the auditor should document his or her understanding of internal control.

Choice "a" is incorrect. A scope limitation significant enough to result in a qualified opinion occurs when the auditor is unable to perform a desired procedure or an acceptable alternative procedure. If documentation supporting procedures and organizational structure is not available, the auditor will need to put forth more effort to obtain an understanding of internal control. This lack of documentation does not, however, reduce the auditor's responsibility to assess the effectiveness of internal controls, nor would it result in a qualified opinion.

Choice "c" is incorrect. Failure to maintain documentation supporting procedures and organizational structure does not necessarily imply that control risk is high. It is possible that controls are operating effectively even if they are not appropriately documented.

Choice "d" is incorrect. Although it is helpful when the auditor can review client procedures manuals and organizational flowcharts, not having this documentation simply means that the auditor will need to put forth more effort to obtain an understanding of internal control. This lack of client documentation does not reduce the auditor's responsibility to assess the effectiveness of internal controls.

9.

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.

ANSWER:

Choice "a" is correct. Objectivity is reflected by the organizational level to which the internal auditor reports.

Choice "b" is incorrect. Competency, not objectivity, is reflected by the professional certifications of the internal audit staff.

Choice "c" is incorrect. Competency, not objectivity, is reflected by the consistency of the internal audit reports with the results of work performed.

Choice "d" is incorrect. Competency, not objectivity, is reflected by the appropriateness of internal audit conclusions in the circumstances.

10.

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.

ANSWER:

Choice "a" is correct. Income statement accounts tend to be more predictable than balance sheet accounts, and therefore interest expense would likely yield a higher level of evidence than the allowance for doubtful accounts, accounts receivable, or accounts payable.

Choice "b" is incorrect. The allowance for doubtful accounts is affected by write-offs of specific receivables, which is not particularly predictable.

Choice "c" is incorrect. Accounts receivable is affected by payments received from customers, which is not particularly predictable.

Choice "d" is incorrect. Accounts payable is affected by payments made at the discretion of the client, which may not be particularly predictable.

11.

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.

ANSWER:

Choice "d" is correct. Statements on Standards for Accounting and Review Services apply when an accountant "submits" unaudited financial statements of a nonissuer. Submission is defined as presenting financial statements to a client or third party, where those financial statements would not otherwise have existed. Neither reproducing client-prepared financial statements nor preparing standard monthly journal entries constitutes submission, and therefore SSARS does not apply.

Choices "a", "b", and "c" are incorrect, based on the above explanation.

12.

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.

ANSWER:

Choice "b" is correct. The auditor should discuss with management the controls adopted to identify, evaluate, and account for litigation.

Choice "a" is incorrect. The clerk of the court would not have any information regarding whether or not litigation is properly disclosed in the financial statements.

Choice "c" is incorrect. The auditor does not generally inspect documents held by the client's lawyer, but rather relies on the lawyer's written response to the audit inquiry letter.

Choice "d" is incorrect. It would be inappropriate for the auditor to contact the legal representatives of the client's adversaries.

13.

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.

ANSWER:

Choice "b" is correct. Before reissuing a compilation report on the financial statements of a nonissuer for the prior year, the predecessor accountant is required to compare the prior year's financial statements with those of the current year.

Choice "a" is incorrect. Before reissuing a compilation report on the financial statements of a nonissuer for the prior year, the predecessor accountant should obtain a representation letter from the successor accountants. An updated management representation letter is not required.

Choice "c" is incorrect. The predecessor accountant is not required to review the successor accountant's working papers, especially since it is unlikely that the current year documentation includes information relevant to the previous year's financial statements.

Choice "d" is incorrect. The predecessor accountant is not required to make inquiries of the entity's lawyers concerning continuing litigation.

14.

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.

ANSWER:

Choice "b" is correct. In a review of a nonissuer's financial statements, an accountant should inquire about the existence of related party transactions.

Choice "a" is incorrect. In a review of a nonissuer's financial statements, the successor accountant may decide (but is not required) to communicate with the predecessor accountant.

Choice "c" is incorrect. In a review of a nonissuer's financial statements, an accountant is not required to perform audit procedures such as corroboration or verification.

Choice "d" is incorrect. In a review of a nonissuer's financial statements, an accountant is not required to obtain an understanding of or test internal control, or to communicate internal control deficiencies to senior management.

15.

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.

ANSWER:

Choice "b" is correct. A lack of independent checks is a fraud risk factor that provides an opportunity for misappropriation of assets.

Choice "a" is incorrect. A high turnover of senior management may evidence an unstable organizational structure, which is a fraud risk factor that provides an opportunity for fraudulent financial reporting.

Choice "c" is incorrect. A strained relationship between management and the predecessor auditor evidences an attitude that may be considered a fraud risk factor for fraudulent financial reporting.

Choice "d" is incorrect. An inability to generate cash flow from operations may evidence a threat to the company's financial stability or profitability, providing an incentive for fraudulent financial reporting.

16.

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.

ANSWER:

Choice "d" is correct. An accountant who is not independent with respect to an entity may compile financial statements for such an entity and issue a report. The last paragraph of the report should disclose this lack of independence, but should not disclose the reasons.

Choice "a" is incorrect. A compilation in accordance with SSARS does not require analytical procedures.

Choice "b" is incorrect. An accountant provides no assurance (not even negative assurance) based on a compilation in accordance with SSARS.

Choice "c" is incorrect. A compilation in accordance with SSARS does not require inquiry of management or examination of internal controls.

17.

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.

ANSWER:

Choice "d" is correct. In a review of a nonissuer's financial statements, an accountant should inquire about actions taken at board of directors meetings.

Choice "a" is incorrect. In a review of a nonissuer's financial statements, an accountant is not required to perform audit procedures such as verification of financial statement estimates.

Choice "b" is incorrect. In a review of a nonissuer's financial statements, an accountant is not required to obtain an understanding of or test internal control.

Choice "c" is incorrect. In a review of a nonissuer's financial statements, an accountant is not required to assess the entity's ability to continue as a going concern. However, if information comes to the accountant's attention indicating that there may be a going concern issue, the accountant should request management to consider the effects of any such uncertainties on the financial statements.

18.

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.

ANSWER:

Choice "c" is correct. In evaluating the reasonableness of estimates, the auditor focuses on assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or subjective and susceptible to misstatement or bias

Choice "a" is incorrect. In evaluating the reasonableness of estimates, the auditor would not normally concentrate on assumptions that are stable and insensitive to variation. Estimates based on such assumptions are less likely to be misstated.

Choice "b" is incorrect. In evaluating the reasonableness of estimates, the auditor would not normally concentrate on assumptions that are objective and not susceptible to bias. Estimates based on such assumptions are less likely to be misstated.

Choice "d" is incorrect. In evaluating the reasonableness of estimates, the auditor would not normally concentrate on assumptions that are similar to industry guidelines. Estimates based on such assumptions are less likely to be misstated.

19.

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.

ANSWER:

Choice "a" is correct. An unqualified opinion states that the financial statements are presented fairly, in all material respects. Since the collective effect of the proposed adjustments is immaterial, an unqualified opinion without modification should be expressed. In addition, footnote disclosure of proposed immaterial adjustments is not required.

Choice "b" is incorrect. The AICPA defines fair presentation as reflecting the underlying transactions of a company in a manner that represents the financial statements within a range of acceptable limits. Since the collective effect of the proposed adjustments is immaterial, the financial statements would be considered to conform to generally accepted accounting principles.

Choice "c" is incorrect. An unqualified opinion states that the financial statements are presented fairly, in all material respects. Since the collective effect of the proposed adjustments is immaterial, an unqualified opinion without modification should be expressed.

Choice "d" is incorrect. The AICPA defines fair presentation as reflecting the underlying transactions of a company in a manner that represents the financial statements within a range of acceptable limits. Since the collective effect of the proposed adjustments is immaterial, the financial statements would be considered to conform to generally accepted accounting principles, and footnote disclosure of the proposed adjustments would not be required.

20.

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.

ANSWER:

Choice "d" is correct. It is the auditor's responsibility to evaluate the ability of the client to continue as a going concern. The attorney would not make such an evaluation.

Choice "a" is incorrect. An audit inquiry letter should include inquiry regarding all significant matters that may result in litigation, and the attorney would likely respond to all such matters, not just one specific matter. In addition, an audit inquiry letter should include inquiry regarding an estimate of potential loss, so this too would likely be addressed in the attorney's response.

Choice "b" is incorrect. An audit inquiry letter should include inquiry regarding the progress of the case to date and management's intended response, and the attorney would likely address these issues in his/her response.

Choice "c" is incorrect. An audit inquiry letter should include inquiry regarding the degree of probability of an unfavorable outcome, and the amount or estimate of potential loss. The attorney would likely address these issues in his/her response.

21.

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.

ANSWER:

Choice "d" is correct. If, as a result of the work performed by the specialist, the auditor decides to add explanatory language, the auditor may refer to the specialist in the auditor's report.

Choice "a" is incorrect. As long as the auditor is expressing a standard unqualified opinion, no reference should be made to the work of the specialist.

Choice "b" is incorrect. As long as the auditor is expressing a standard unqualified opinion, no reference should be made to the work of the specialist.

Choice "c" is incorrect. As long as the auditor is expressing a standard unqualified opinion, no reference should be made to the work of the specialist.

22.

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.

ANSWER:

Choice "c" is correct. An accountant who is not independent with respect to an entity may compile financial statements for such an entity and issue a report. However, the last paragraph of the report should disclose this lack of independence.

Choice "a" is incorrect. An accountant who is not independent with respect to an entity may compile financial statements for such an entity and issue a report. However, the last paragraph of the report should disclose this lack of independence.

Choice "b" is incorrect. No assurance (not even negative assurance) is provided in a compilation report.

Choice "d" is incorrect. If the engagement is upgraded to a review, a review report would be issued. However, note that an accountant must be independent in order to issue a review report.

23.

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.

ANSWER:

Choice "c" is correct. A trade receivable existing at the date of the financial statements that subsequently becomes uncollectible because of bankruptcy of the customer requires an adjustment to the financial statements.

Choice "a" is incorrect. Significant business events occurring subsequent to the date of financial statements, such as a loss resulting from a flood, require no adjustment to the statements, but may require significant additional disclosure.

Choice "b" is incorrect. Settlement in year 2 of litigation related to a year 2 event would not require adjustment to the year 1 financial statements, but would require disclosure in the financial statements.

Choice "d" is incorrect. Proceeds from a capital stock issuance in year 2 would not require adjustment to the year 1 financial statements, but would require disclosure in the financial statements.

24.

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.

ANSWER:

Choice "b" is correct. Engagement performance is one of the five interrelated elements of quality control.

Choice "a" is incorrect. Information processing is not one of the five interrelated elements of quality control.

Choice "c" is incorrect. Technology selection is not one of the five interrelated elements of quality control.

Choice "d" is incorrect. Professional skepticism is not one of the five interrelated elements of quality control.

25.

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.

ANSWER:

Choice "b" is correct. In obtaining evidence about subsequent events, the auditor should examine the latest available interim financial statements, and compare them with the financial statements under audit.

Choice "a" is incorrect. Changes in quoted market prices subsequent to year end are to be expected, and would not provide information about subsequent events.

Choice "c" is incorrect. Applying analytical procedures to the details of the balance sheet accounts that were tested at interim dates is part of testing the year-end financial statements, not part of obtaining evidence about subsequent events.

Choice "d" is incorrect. Payroll checks that are recorded before year end are not subsequent events, even if they are not cashed until after year end.

26.

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.

ANSWER:

Choice "c" is correct. In the event of omitted audit procedures, the auditor should first attempt to perform alternative procedures in order to ascertain whether the original opinion can be relied upon.

Choice "a" is incorrect. The auditor would only advise the client to notify creditors that the unqualified opinion cannot be relied upon if the auditor cannot become satisfied (by performing alternative procedures) as to the propriety of the original opinion.

Choice "b" is incorrect. The auditor may need to reissue the audit report if the auditor is unable to become satisfied by using alternative procedures; however, the opinion issued would be qualified or disclaimed, due to the scope limitation, and would not simply have an explanatory paragraph added.

Choice "d" is incorrect. The auditor would only advise the client to disclose this development in its next interim report if the auditor cannot become satisfied (by performing alternative procedures) as to the propriety of the original opinion.

27.

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.

ANSWER:

Choice "d" is correct. Reviewing purchase contracts and other legal documents might aid the auditor in identifying omitted liabilities (for example, an obligation to make a certain purchase, or a document evidencing a lawsuit).

Choice "a" is incorrect. Inquiry of senior support staff and recently departed employees is unlikely to detect a liability omission by management, since management probably would not have allowed this information to become well-known among employees.

Choice "b" is incorrect. If a liability is mistakenly omitted from recording, it will not be in the financial statements. Therefore, such an omission is unlikely to be detected by checking the mathematical accuracy of the financial statements.

Choice "c" is incorrect. While reviewing the articles of incorporation and corporate bylaws provides good background information about a company, these procedures would be unlikely to provide evidence regarding omission of a liability in the current year's financial statements.

28.

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 flow chart of the duties performed and the entity's available personnel.

ANSWER:

Choice "b" is correct. Evidence concerning proper segregation of duties is generally obtained through inspection and observation.

Choice "a" is incorrect. Completing an internal control questionnaire might aid the auditor in understanding how controls are supposed to work, but it does not provide evidence with respect to whether controls are actually functioning as designed.

Choice "c" is incorrect. Performing substantive tests to verify details about a bank balance provides evidence as to whether the balance is fairly stated, not whether controls surrounding the account are operating effectively.

Choice "d" is incorrect. Preparing a flow chart of the duties performed and the entity's available personnel might aid the auditor in understanding how controls are supposed to work, but it does not provide evidence with respect to whether controls are actually functioning as designed.

29.

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.

ANSWER:

Choice "b" is correct. Shipping documents and receiving reports are internally-generated evidence, since they are created by the client rather than received from independent sources outside the enterprise.

Choice "a" is incorrect. Customer purchase orders and bank statements are both external evidence, since they are received from independent sources outside the enterprise.

Choice "c" is incorrect. Vendor invoices and packing slips are both external evidence, since they are received from independent sources outside the enterprise.

Choice "d" is incorrect. Bills of lading and accounts receivable confirmations are both external evidence, since they are received from independent sources outside the enterprise.

30.

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.

ANSWER:

Choice "d" is correct. Before issuing a compilation report, accountants should read the compiled financial statements and consider whether they are appropriate in form and free from obvious material errors.

Choice "a" is incorrect. The accountant is not required to make inquiries during a compilation engagement. Performance requirements are generally limited to having an understanding of the industry and business and reading the financial statements.

Choice "b" is incorrect. The accountant is not required to determine whether there is substantial doubt about the entity's ability to continue as a going concern during a compilation engagement. (However, if an accountant becomes aware that there is a going concern uncertainty, he or she should request management to consider the effect on the financial statements, evaluate management's conclusions, and consider the effect of the matter on the compilation report.)

Choice "c" is incorrect. The accountant is not required to scan the entity's records or to identify subsequent events during a compilation engagement. (However, if an accountant becomes aware that a subsequent event has occurred, he or she should request management to consider the effect on the financial statements, evaluate management's conclusions, and consider the effect of the matter on the compilation report.)

31.

Which of the following best represents a key control for ensuring sales are properly authorized when assessing 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.

ANSWER:

Choice "d" is correct. Proper authorization for sales involves obtaining credit approval before filling the order.

Choice "a" is incorrect. Separation of duties between billing and cash receipts relates to the prevention of theft of cash, not to proper authorization of sales.

Choice "b" is incorrect. The use of an approved price list to determine selling price relates to the accuracy and appropriateness of selling price, not to the proper authorization of the sale.

Choice "c" is incorrect. Sending copies of approved sales orders to shipping, billing, and accounting provides information necessary to ensure that the proper goods are shipped, the invoice is prepared appropriately, and the sale and receivable are properly recorded. However, since it is copies of *approved* sales orders that are being sent, this procedure comes too late in the process to assure that sales were properly authorized in the first place.

32.

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.

ANSWER:

Choice "c" is correct. Providing limited assurance that the financial statements of a nonissuer require no material modifications to be in accordance with GAAP is a review engagement. In a review engagement, the accountant must be familiar with the accounting principles common to the client's industry.

Choice "a" is incorrect. Providing limited assurance that the financial statements of a nonissuer require no material modifications to be in accordance with GAAP is a review engagement. No fraud risk assessment is required in a review.

Choice "b" is incorrect. Providing limited assurance that the financial statements of a nonissuer require no material modifications to be in accordance with GAAP is a review engagement. The accountant is not required to perform tests of internal control in a review engagement.

Choice "d" is incorrect. Providing limited assurance that the financial statements of a nonissuer require no material modifications to be in accordance with GAAP is a review engagement. The accountant is not required to communicate with the audit committee regarding material weaknesses in internal control in a review engagement.

33.

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.

ANSWER:

Choice "c" is correct. Competence is reflected by education, professional certification, experience, performance evaluations, the audit plan, audit procedures, and the quality of audit documentation.

Choice "a" is incorrect. Objectivity, not competency, is reflected by the influence of management on the scope of the internal auditors' duties.

Choice "b" is incorrect. Objectivity, not competency, is reflected by limitations placed on communications between the internal auditor and the audit committee.

Choice "d" is incorrect. Obtaining information about the entity's ability to continue as a going concern would not provide any information about the competence of internal auditors.

34.

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.

ANSWER:

Choice "c" is correct. Obtaining a letter of audit inquiry from the client's lawyer may aid the auditor in evaluating loss contingencies.

Choice "a" is incorrect. Checking the arithmetic accuracy of accounting records would not be likely to provide information regarding loss contingencies.

Choice "b" is incorrect. Performing appropriate analytical procedures would not be likely to provide information regarding loss contingencies.

Choice "d" is incorrect. Reading the financial statements, including footnotes would not be likely to provide information regarding loss contingencies.

35.

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.

ANSWER:

Choice "c" is correct. The auditor's direct personal observation provides the most reliable evidence about whether access to the data center is being appropriately limited.

Choice "a" is incorrect. Inspecting the policy manual provides evidence about whether the design of access controls is appropriate, but not whether such controls are operating effectively.

Choice "b" is incorrect. Asking the chief technology officer about known problems provides some evidence about access controls, but it is not as reliable as the auditor's direct personal observation.

Choice "d" is incorrect. Obtaining a list of current data center employees does not provide any evidence regarding whether access is appropriately limited to those employees.

36.

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.

ANSWER:

Choice "b" is correct. Detection risk can be changed at the auditor's discretion, whereas control risk and inherent risk exist independently of the financial statement audit, and cannot be changed by the auditor.

Choice "a" is incorrect. Detection risk is a function of the effectiveness of audit procedures and of the manner in which they are applied, so it does not exist independently of the financial statement audit.

Choice "c" is incorrect. Detection risk is a function of the effectiveness of audit procedures and of the manner in which they are applied. It does not arise from risk factors relating to fraud.

Choice "d" is incorrect. The components of audit risk (including detection risk) may be assessed either quantitatively (e.g., as a percentage), or non-quantitatively (e.g., high, medium, low, etc.).

37.

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.

ANSWER:

Choice "a" is correct. To provide assurance that each voucher is submitted and paid only once, an auditor should verify that each voucher was stamped “paid” by the check signer.

Choice "b" is incorrect. Paid vouchers should be returned to the accounting department for posting of the payment and filing of the documents, but this does not prevent the voucher from inadvertently being paid twice before it is returned to accounting.

Choice "c" is incorrect. Vouchers should be supported by a vendor's invoice and purchase order, but this does not prevent the same voucher from inadvertently being paid twice.

Choice "d" is incorrect. Vouchers should be prenumbered and accounted for, but this does not prevent the same voucher from inadvertently being paid twice.

38.

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.

ANSWER:

Choice "c" is correct. In an engagement to review the financial statements of a nonissuer, the accountant is required to perform analytical procedures, which might include analysis of ratios such as inventory turnover.

Choice "a" is incorrect. In an engagement to review the financial statements of a nonissuer, the accountant is not required to perform audit procedures, such as inspecting or vouching.

Choice "b" is incorrect. In an engagement to review the financial statements of a nonissuer, the accountant is not required to perform audit procedures, such as inspecting or vouching.

Choice "d" is incorrect. In an engagement to review the financial statements of a nonissuer, the accountant is not required to evaluate internal control.

39.

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.

ANSWER:

Choice "b" is correct. An external inquiry of the entity's attorney is the auditor's primary means of obtaining verification of management information pertaining to litigation, claims, and assessments.

Choice "a" is incorrect. The attorney is an expert in litigation, claims, and assessment, and can provide information about the nature of the matter, progress of the case, degree of probability of an unfavorable outcome, and estimate of potential loss. However, the attorney is not an expert in accounting and would not provide assurance regarding the accounting for such matters.

Choice "c" is incorrect. Although the attorney does provide a description of litigation, claims, and assessments that have a reasonable possibility of unfavorable outcomes, this is only a portion of what the attorney provides, and is not the primary reason for the request. The primary reason for the request is to obtain verification of management information pertaining to litigation, claims, and assessments.

Choice "d" is incorrect. The attorney does provide information regarding the degree of probability of an unfavorable outcome, but evaluating whether loss contingencies are possible, probable, or remote is not the primary reason for the request. The primary reason for the request is to obtain verification of management information pertaining to litigation, claims, and assessments.

40.

Which of the following is an inherent limitation of internal controls?

- a. Judgmental sampling.
- b. Collusion.
- c. Segregation of duties.
- d. Employee peer review.

ANSWER:

Choice "b" is correct. Inherent limitations of internal control include collusion, human error, and management override.

Choice "a" is incorrect. Sampling is used in most audit applications, since it is generally not feasible to examine 100% of a population, but this is not an inherent limitation of internal control.

Choice "c" is incorrect. Segregation of duties may be difficult to achieve in a small entity, and this can be viewed as an inherent limitation in internal control for such entities. However, this question does not mention the size of the entity, and generally speaking, segregation of duties is a control activity, not an inherent limitation of internal control.

Choice "d" is incorrect. Peer review is a form of monitoring, which is a control activity, not an inherent limitation of internal control.

41.

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.

ANSWER:

Choice "c" is correct. Detecting a possible understatement in sales is tantamount to testing completeness (i.e., if an understatement is found, sales are not complete). To test completeness, one needs to start with supporting documentation, such as shipping documents, and trace forward to recording in the accounting records, such as the sales journal. Should the auditor find a shipping document for which there is no entry in the sales journal, an understatement error (or a completeness problem) will have been discovered.

Choice "a" is incorrect. Tracing from the accounting records, such as sales invoices, to supporting documentation, such as shipping documents, tests for overstatement, or tests existence. Should the auditor find a sales invoice for which there is no shipping document, an overstatement error will have been discovered (i.e., perhaps a fictitious sale has been recorded).

Choice "b" is incorrect. Tracing from the cash receipts journal to the sales journal may help the auditor verify whether the receipt was properly recorded (i.e., once one knows to which sale the receipt relates, one can verify whether the appropriate customer balance was reduced), but it does not aid the auditor in detecting possible understatements of sales. In order to detect understatements, one must trace from supporting documentation to accounting records, not compare internal consistency among accounting records.

Choice "d" is incorrect. Tracing from the sales journal to the cash receipts journal aids the auditor in identifying sales for which payment has not yet been received, but it does not aid the auditor in detecting possible understatements of sales. In order to detect understatements, one must trace from supporting documentation to accounting records, not compare internal consistency among accounting records.

42.

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.

ANSWER:

Choice "a" is correct. Plans to delay expenditures, such as extending the due dates of existing loans, would be considered a mitigating factor.

Choice "b" is incorrect. Plans to reduce expenditures would be considered a mitigating factor, but operating at increased levels of production would likely increase expenditures, not reduce them.

Choice "c" is incorrect. Plans to delay expenditures would be considered a mitigating factor. Accelerating expenditures would not be a mitigating factor, as it would tend to reduce cash flow even further.

Choice "d" is incorrect. Issuance of stock options does not provide an inflow of cash, and would not be a mitigating factor. (Remember that options would only provide an inflow of cash if they were exercised.)

43.

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.

ANSWER:

Choice "d" is correct. The date on a compilation report should be the date of completion of the compilation.

Choice "a" is incorrect. An accountant who is not independent with respect to an entity may compile financial statements for such an entity and issue a report. The last paragraph of the report should disclose this lack of independence.

Choice "b" is incorrect. A compilation report states that information that is the representation of management is being presented in the form of financial statements. The report would not include a statement indicating that the information is the representation of the accountant, since this is not the case.

Choice "c" is incorrect. A compilation report does not include a description of the very minimal procedures performed during the compilation.

44.

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).

ANSWER:

Choice "b" is correct. The literature pertaining to GAAP changes over time, and therefore generally accepted accounting principles can be said to encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time.

Choice "a" is incorrect. The literature pertaining to GAAP does provide detailed practices and procedures.

Choice "c" is incorrect. The phrase "generally accepted accounting principles" does not provide a measure of conventions, rules, and procedures governed by the AICPA, since the AICPA actually governs a broad area that goes well beyond accounting principles. For example, the AICPA provides Statements on Auditing Standards, which relate to proper performance of a financial statement audit, not to accounting principles.

Choice "d" is incorrect. Inclusion of the phrase "generally accepted accounting principles" in the audit report indicates whether the financial statements are presented in accordance with the conventions, rules, and procedures that define accepted accounting practice. Inclusion of this phrase does not indicate whether the audit has been conducted in accordance with generally accepted auditing standards (GAAS).

45.

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.

ANSWER:

Choice "d" is correct. An independent auditor may accept an engagement after the close of the fiscal year as long as he or she can address any limitations resulting from accepting the engagement at that time. For example, the auditor may not be able to observe the ending inventory count, but may be able to perform acceptable alternative procedures sufficient to support the year-end inventory balance.

Choice "a" is incorrect. Although the auditor may need to issue a disclaimer of opinion on one or a few financial statements if certain audit tests cannot be conducted, it would not make sense for the auditor to accept an audit engagement, the goal of which is to render an opinion, if an overall disclaimer were going to be issued.

Choice "b" is incorrect. The assessment of control risk is irrelevant to the auditor's decision as to whether or not to accept an engagement after the close of the fiscal year.

Choice "c" is incorrect. The auditor should not rely on the preceding auditor's assessment in determining whether or not to accept an engagement after the close of the fiscal year.

46.

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.

ANSWER:

Choice "b" is correct. When issuing letters for underwriters, commonly referred to as comfort letters, an accountant may provide negative assurance concerning the conformity of the entity's unaudited condensed interim financial information with generally accepted accounting principles (GAAP).

Choice "a" is incorrect. Comments in a comfort letter are limited to financial information.

Choice "c" is incorrect. Accountants may not provide negative assurance on the results of procedures performed in compiling an entity's financial forecast. Accountants may attach to the comfort letter a standard report on a compilation of the forecast, and may include additional procedures and findings in the comfort letter, but may not provide any form of assurance on the forecast.

Choice "d" is incorrect. When issuing letters for underwriters, commonly referred to as comfort letters, an accountant typically provides positive assurance concerning the compliance of the financial statements and financial statement schedules included in the registration statement with the requirements of the Securities Act of 1933.

47.

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.

ANSWER:

Choice "c" is correct. An accountant is required to comply with the provisions of the *Statements on Standards for Accounting and Review Services* when generating financial statements of a nonissuer.

Choice "a" is incorrect. *Statements on Standards for Accounting and Review Services* do not apply to other accounting services provided by the accountant, such as preparing monthly journal entries.

Choice "b" is incorrect. *Statements on Standards for Accounting and Review Services* do not apply to other accounting services provided by the accountant, such as providing the client with software to generate financial statements.

Choice "d" is incorrect. *Statements on Standards for Accounting and Review Services* do not apply to other accounting services provided by the accountant, such as providing a blank financial statement format or template.

48.

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.

ANSWER:

Choice "c" is correct. The accountant's report in a compilation engagement should include a statement that a compilation is limited to presenting, in the form of financial statements, information that is the representation of management.

Choice "a" is incorrect. The accountant should not provide any form of assurance with respect to compiled financial statements.

Choice "b" is incorrect. The standard compilation report does not compare the scope of a compilation engagement with that of an audit engagement.

Choice "d" is incorrect. An audit, not a compilation, is performed to obtain reasonable assurance about whether the financial statements are free from material misstatement.

49.

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.

ANSWER:

Choice "b" is correct. 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 the likelihood of associating with clients whose management lacks integrity is minimized.

Choice "a" is incorrect. A CPA firm does have a duty to the public with respect to performance of an audit, but this applies more generally to the ethical responsibilities of CPAs and to the exercise of due care in performing the audit, not specifically to the decision regarding whether to accept a new client.

Choice "c" is incorrect. Whether or not client-prepared schedules are completed on a timely basis is not generally a consideration in accepting a new client.

Choice "d" is incorrect. While it is true that an expected lack of evidence may cause the auditor to decline an engagement, ensuring that sufficient corroborating evidence will be available is not the purpose of establishing quality control policies and procedures. Even if sufficient corroborating evidence is expected to be available, an appropriate quality control system should still prevent the acceptance of a new client whose management lacks integrity.

50.

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.

ANSWER:

Choice "b" is correct. Accounts receivable turnover is calculated as net sales divided by average receivables, or 10 and 6.7 in the previous year and current year, respectively. The decline in the turnover ratio indicates that while both sales and accounts receivable have increased, accounts receivable have increased proportionately more than would be expected for the increase in sales. (Another way to look at this is to note that while sales doubled, accounts receivable tripled.) Meanwhile, the allowance for doubtful accounts has dropped from 30% of receivables to only 17%. The overall increase in receivables combined with the decrease in the percentage of receivables offset by the allowance, would cause the auditor to examine the allowance for possible understatement.

Calculations:

$$1,000,000/100,000 = 10$$

$$2,000,000/300,000 = 6.7 \text{ (rounded from 6.66666...)}$$

$$30,000/100,000 = .30$$

$$50,000/300,000 = .17 \text{ (rounded from 1.66666...)}$$

Note that the ratios provided on the exam were not rounded properly, but option b was still the best answer, given the choices provided.

Choices "a", "c", and "d" are incorrect, based on the above explanation.