101. For which of the following ledger accounts would the auditor be most likely to analyze the details?
a) Service revenue.
b) Sales.
c) Repairs and maintenance expense.
d) Sales salaries expense.

Answer A is incorrect because service revenue is frequently tested through analytical procedures and tests of controls.

Answer B is incorrect because sales is more frequently tested through analytical procedures and tests of controls.

Answer C is correct because erroneously expensing capital acquisitions is a frequent accounting error.

Answer D is incorrect because sales salaries expense is more frequently tested through analytical procedures and tests of controls.

102. The auditor is least likely to learn of retirements of equipment through which of the following?
a) Review of the purchase return and allowance account.
b) Review of depreciation.
c) Analysis of the debits to the accumulated depreciation account.
d) Review of insurance policy riders.

Answer A is correct because the purchase return and allowance account is credited upon the return of merchandise purchased by the client. There is no relationship between merchandise returned and the retirement of equipment.

Answer B is incorrect because equipment retirements will reduce depreciation.

Answer C is incorrect because debits to the accumulated depreciation account arise when equipment is retired.

Answer D is incorrect because insurance policy riders are often added for new equipment which replaces old equipment that has been retired.

103. Which of the following accounts should be reviewed by the auditor to gain reasonable assurance that additions to property, plant, and equipment are not understated?
a) Depreciation.
b) Accounts payable.
c) Cash.
d) Repairs.

Answer A is incorrect because it is unlikely that depreciation will be taken on assets which have not been capitalized.

Answer B is incorrect because even if the item has been set up in accounts payable, it may not have been capitalized properly; the debit portion of the entry may be in the repairs expense account.

Answer C is incorrect because most entries to cash will be for payment of accounts payable which have already been established. Thus, the auditor would not gain assurance regarding additions to property, plant, and equipment.

Answer D is correct because the repairs expense account may include additions that have been erroneously expensed. Thus, the auditor's review of the repairs account would reveal a possible understatement of additions to property, plant, and equipment.

104. The auditor may conclude that depreciation charges are insufficient by noting
a) Large amounts of fully depreciated assets.
b) Continuous trade-ins of relatively new assets.
c) Excessive recurring losses on assets retired.
d) Insured values greatly in excess of book values.

Answer A is incorrect because large amounts of fully depreciated assets which are still being used could indicate excess past depreciation charges.

Answer B is incorrect because continuous trade-ins of relatively new assets does not directly indicate whether an adequate amount of depreciation has been recorded.

Answer C is correct. The requirement is to identify the situation which is consistent with insufficient depreciation charges. Excessive recurring losses on retired assets indicate that an inadequate portion of the cost of the asset has been charged to expense during the asset's life. This results in a NBV which is far above the asset's market value and, in turn, a loss on the retired asset.

Answer D is incorrect because inflation may cause firms to insure assets for amounts greatly in excess of book values.

105. Which of the following explanations might satisfy an auditor who discovers significant debits to an accumulated depreciation account?
a) Extraordinary repairs have lengthened the life of an asset.
b) Prior year’s depreciation charges were erroneously understated.
c) A reserve for possible loss on retirement has been recorded.
d) An asset has been recorded at its fair value.

Answer A is correct. The requirement is to determine an explanation for significant debits to accumulated depreciation. Extraordinary repairs which lengthen the life of an asset are properly accounted for by debiting the accumulated depreciation account.

Answer B is incorrect because understated past depreciation would require a credit in accumulated depreciation.

Answer C is incorrect because a reserve for a possible loss would not decrease past depreciation.

Answer D is incorrect because an auditor would not be satisfied with an increase in the asset's book value to its fair value.

106. Which of the following audit procedures would be least likely to lead the auditor to find unrecorded fixed asset disposals?

a) Examination of insurance policies.
b) Review of repairs and maintenance expense.
c) Review of property tax files.
d) Scanning of invoices for fixed asset additions.

Answer A is incorrect because examination of insurance policies would reveal acquisitions of new assets added to the policy and would raise the question of related asset disposals.

Answer B is correct because a review of repairs and maintenance expense would only point out unrecorded fixed asset disposals if repair and maintenance expense decreased drastically and there were no recorded fixed asset disposals.

Answer C is incorrect because review of property tax files and changes therein would indicate possible asset disposals.

Answer D is incorrect because fixed asset additions are frequently accompanied by disposals of assets that are being replaced. Thus, the additions would indicate possible disposal of assets.

107. Patentex developed a new secret formula which is of great value because it resulted in a virtual monopoly. Patentex has capitalized all research and development costs associated with this formula. Jovy, CPA, who is examining this account, will probably

a) Confer with management regarding transfer of the amount from the balance sheet to the income statement.
b) Confirm that the secret formula is registered and on file with the county clerk's office.
c) Confer with management regarding a change in the title of the account to "goodwill".
d) Confer with management regarding ownership of the secret formula.

Answer A is correct because the proper accounting for research and development costs is to expense them in the period incurred. Therefore, the firm's capitalization of the expenditures is likely to be of concern to the auditor.

Answer B is incorrect because the county clerk will probably not have registered the secret formula.

Answer C is incorrect because the costs do not qualify as goodwill.

Answer D is incorrect because the fact that Patentex developed the formula would indicate that ownership is not the primary topic of concern here.

108. In verifying the amount of goodwill recorded by a client, the most convincing evidence which an auditor can obtain is by comparing the recorded value of assets acquired with the

a) Assessed value as evidence by tax bills.

b) Seller's book value as evidence by financial statements.

c) Insured value as evidences by insurance policies.

d) Appraised value as evidence by independent appraisals.

Answer A is incorrect because assessed tax values may deviate from the value to be recorded under generally accepted accounting principles.

Answer B is incorrect because the seller's book value is not relevant to the value at which the purchaser should record the assets.

Answer C is incorrect because for valid business reasons a firm may insure its assets for other than their cost.

Answer D is correct. The requirement is to determine the most convincing evidence with respect to recorded goodwill. Identifiable assets acquired in a "purchase" business combination should be recorded at their appraised values.

109. In the examination of property, plant, and equipment, the auditor tries to determine all of the following except the

a) Adequacy of internal control.

b) Extent of property abandoned during the year.

c) Adequacy of replacement funds.

d) Reasonableness of the depreciation.

Answer A is incorrect because an auditor will test the adequacy of internal control.

Answer B is incorrect because abandoned property must be properly reflected in the financial statements.

Answer C is correct because determining whether adequate replacement funds exist is not a primary audit objective. Replacement does not bear directly on the fairness of presentation in conformity with GAAP.

Answer D is incorrect because an auditor must determine whether the client's depreciation is reasonable.

110. An auditor would be least likely to use confirmations in connection with the examination of

a) Inventories.

b) Long-term debt.

c) Property, plant and equipment.

d) Stockholders' equity.

Answer A is incorrect because confirmations may be used effectively for inventories which are, for example, consigned.

Answer B is incorrect because long-term creditors will generally keep current records of amounts owed them and this will make the use of confirmations effective.

Answer C is correct because an effective confirmation should be sent to parties who are likely to be able to respond meaningfully. In the case of property, plant, and equipment, those who supplied the item(s) may not have adequate records on historic sales and, therefore, will not be able to respond to the confirmation meaningfully.

Answer D is incorrect because stockholders can reply as to the amount of stock they hold and, thus, confirmations can be effectively used.

111. With respect to a small company's system of purchasing supplies, an auditor's primary concern should be to obtain satisfaction that supplies ordered and paid for have been

a) Requested by and approved by authorized individuals who have no incompatible duties.
b) Received, counted and checked to quantities and amounts on purchase orders and invoices.
c) Properly recorded as assets and systematically amortized over the estimated useful life of the supplies.
d) Used in the course of business and solely for business purposes during the year under audit.

Answer A is incorrect because in a small company there may be authorized individuals who have what would normally be considered incompatible duties.

Answer B is correct because receiving, counting, and checking the quantities on purchase orders provides control over supplies which have already been purchased and paid for.

Answer C is incorrect because supplies are expensed as used, not amortized over their useful life.

Answer D is incorrect because the supplies may remain unused as of the end of the period under audit.

112. Which of the following procedures relating to the examination of accounts payable could the auditor delegate entirely to the client's employees?

a) Test footings in the accounts payable ledger.
b) Reconcile unpaid invoices to vendors' statements.
c) Prepare a schedule of accounts payable.
d) Mail confirmation for selected account balances.

Answer A is incorrect since the auditor should test the various footings to verify clerical accuracy.

Answer B is incorrect because, while client assistance may be obtained in such reconciliation of invoices to statements, the auditor will generally wish to review such work.

Answer C is correct because preparation of a schedule of accounts payable is a client's accounting function which is used by the auditor during the corroboration of the accounts payable control account.

Answer D is incorrect because the auditor should mail the confirmations to verify that they are correct and are actually sent to the debtor.

113. In order to efficiently establish the correctness of the accounts payable cutoff, an auditor will be most likely to

a) Coordinate cutoff test with physical inventory observation.
b) Compare cutoff reports with purchase orders.
c) Compare vendors' invoices with vendors' statements.
d) Coordinate mailing of confirmations with cutoff tests.

Answer A is correct because the auditor seeks to determine that both sides of the purchase transaction, inventory acquisition, and accounts payable, are treated in the proper period. Thus, payables should exist for items received before year-end and for other goods for which title has passed.

Answer B is incorrect since the purchase order (generally an internal document) is of limited assistance, if any, in determining when title has passed.

Answer C is incorrect because the evidence obtained by comparing invoices with statements does not answer the question of when title passed. In this situation, the auditor seeks to determine that both sides of the purchase transaction are treated in the proper period. To make this determination, the auditor must know when title has passed.

Answer D is incorrect because, although cutoff tests and accounts payable both relate to year-end balances, coordinating the mailing of confirmations is not necessary.

114. Once satisfied that the balance sheet and income statement are fairly presented in accordance with generally accepted accounting principles, an auditor who is examining the statement of cash flows would be most concerned with details of transactions in

a) Cash.
b) Trade receivables.
c) Notes receivable.
d) Dividends payable.

Answer A is incorrect because the auditor analyzes the changes in the noncurrent accounts rather than the cash account if a working capital format is used. If a cash format is used, the auditor also analyzes the individual changes in the noncurrent accounts as well as the gross changes in the current accounts.

Answer B is incorrect. Trade receivables represents a current item, and the net change would be included as an item affecting operations if the statement of cash flows is based upon the cash format.

Answer C is correct. The requirement is to determine the account that the auditor would be most concerned with in the examination of the statement of cash flows after the auditor is satisfied with the balance sheet and income statement. The auditor would examine notes payable (a noncurrent account) to determine financing and investing activities that occurred (i.e., by examining changes in the noncurrent accounts). Each transaction involving notes payable is generally considered a financing and investing activity which requires disclosure. The auditor's interest in notes payable is equally true when the statement of cash flows is based on a working capital approach.

Answer D is incorrect. Dividends payable represents a current item, and the net change would be included as an item affecting operations if the statement of cash flows is based upon the cash format.

115. Which of the following would detect an understatement of a purchase discount?
a) Verify footings and crossfootings of purchase and disbursement records.
b) Compare purchase invoice terms with disbursement records and checks.
c) Compare approved purchase orders to receiving reports.
d) Verify the receipts of items ordered and invoiced.

Answer A is incorrect because verification of purchases and disbursement records would not indicate unrecorded purchase discounts or discounts not taken.

Answer B is correct because by comparing the purchase order with disbursement records and checks, any differences will be detected. The purchase order serves as evidence of the amount payable, and the disbursement records and checks provide evidence of amounts actually paid. Therefore, a comparison will lead to the identification of any understated or unrecorded purchase discounts.

Answer C is incorrect because a comparison of purchase orders to receiving reports does not relate to purchase discounts. The discount terms would appear only on the vendor's invoice.

Answer D is incorrect because verification of items received and the related invoice ignores the payment portion of the transaction where the relevant purchase discount would appear.

116. Auditor confirmation of accounts payable balances at the balance sheet date may be unnecessary because
a) This is a duplication of cutoff tests.
b) Accounts payable balances at the balance sheet date may not be paid before the audit is completed.
c) Correspondence with the audit client’s attorney will reveal all legal action by vendor for nonpayment.
d) There is likely to be other reliable external evidence to support the balnces.

Answer A is incorrect because cutoff tests provide evidence not obtained through confirmation.

Answer B is incorrect because it describes an argument in favor of confirming accounts payable.

Answer C is incorrect because evidence concerning nonpayment of recorded payables would not provide sufficient evidence concerning the existence of unrecorded accounts payable at the balance sheet date.

Answer D is correct because generally, external evidence is available to the auditor to support the accounts payable balance. If the auditor reviews all cash payments for a sufficient period after the balance sheet date for items pertaining to the period under audit and finds no such payments unrecorded at year-end, the auditor is reasonably assured that accounts payable are not materially understated.

117. Which of the following procedures is least likely to be performed before the balance sheet date?
a) Observation of inventory.
b) Review of internal control over cash disbursements.
c) Search for unrecorded liabilities.
d) Confirmation of receivables.

Answer A is incorrect because inventory observation may be performed prior to year-end when internal control is strong.

Answer B is incorrect because internal control procedures are often conducted prior to year-end.

Answer C is correct because the search for unrecorded liabilities is performed near the completion of the audit to determine that proper cutoffs have been made.

Answer D is incorrect because receivables may be confirmed prior to year-end when internal control is strong.

118. When auditing a public warehouse, which of the following is the most important audit procedure with respect to disclosing unrecorded liabilities?
a) Confirmation of negotiable receipts with holders.
b) Review of outstanding receipts.
c) Inspection of receiving and issuing procedures.
d) Observation of inventory.

Answer A is incorrect because confirmation of negotiable instruments may be impractical due to a problem of identifying the holder of the negotiable receipt.

Answer B is incorrect because a review of outstanding receipts cannot be made because the auditor has no knowledge of who may hold "unrecorded" receipts.

Answer C is correct because inspection of receiving and issuing procedures will permit the auditor to thoroughly evaluate the internal control over the custodial responsibilities of the warehouse employee. If the custodial responsibilities are not properly discharged, there may be significant unrecorded liabilities.

Answer D is incorrect because an observation of inventory will only determine what is on hand. The amount of inventories on hand must be coupled with a review of outstanding warehouse receipts to determine any unrecorded liabilities.

119. During an examination the auditor learns that the client was granted a 3-month waiver of the repayment of principal on the installment loan with the bank without an extension of the maturity date.

With respect to this loan, the audit program used by the auditor would be least likely to include a verification of the
a) Interest expense for the year.
b) Balloon payment.
c) Total liability at year-end.
d) Installment loan payments.

Answer A is incorrect because the auditor will need to verify interest expense for the current period on the installment note.

Answer B is correct because the balloon payment due at the end of the note (because the principal was waived for 3 months without extending the maturity date) is not of concern to the presentation of the current period's financial statements.

Answer C is incorrect because the auditor would be very concerned with the proper statement of the year-end liability in the balance sheet.

Answer D is incorrect because the current year's installment loan payments consist of interest expense for the year and reduction of the liability. Thus, the audit program will include a verification of the installment loan payments.

120. Which of the following audit procedures is least likely to detect an unrecorded liability?
a) Analysis and recomputation of interest expense.
b) Analysis and recomputation of depreciation expense.
c) Mailing of standard bank confirmation form.
d) Reading of the minutes of meetings of the board of direction.

Answer A is incorrect because unrecorded debt may be discovered through recomputation of interest expense.

Answer B is correct because an analysis and recomputation of depreciation expense is based upon transactions which have already been recorded (in this case an equipment purchase).

Answer C is incorrect because the standard bank confirmation form explicitly asks for information on liabilities.

Answer D is incorrect because the minutes of the meeting of the board of directors may include discussions of major liabilities incurred by the firm.

121. Which of the following is the best audit procedure for determining the existence of unrecorded liabilities?
a) Examination confirmation requests returned by creditors whose accounts appear on a subsidiary trial balance of accounts payable.
b) Examine unusual relationship between monthly accounts payable balances and recorded purchases.

c) Examination a sample of invoices a few days prior to and subsequent to year-end to ascertain whether they have been properly recorded.
d) Examine a sample of cash disbursements in the period subsequent to year-end.

Answer A is incorrect because it will only be effective for creditors already recorded in the accounts payable ledger. Since the auditor is attempting to determine the existence of unrecorded liabilities, this would not be the best audit procedure to use.

Answer B is incorrect because for unrecorded items it is likely that both the purchases account and the accounts payable account will be understated.

Answer C is incorrect because this procedure would be of limited assistance since only a few days would be involved. Thus, this would not be the best audit procedure to use.

Answer D is correct because the search for unrecorded liabilities is performed near the completion of the audit to determine that proper cutoffs have been made and to give the auditor additional information in his/her evaluations of account balances as of the balance sheet date. One of the principal procedures used to accomplish this objective is the examination of a sample of cash disbursements in the period subsequent to year-end. This examination will allow the auditor to see if any cash disbursements are made for liabilities which were unrecorded in the previous year.

122. When an auditor selects a sample of items from the vouchers payable register for the last month of the period under audit and traces these items to underlying documents, the auditor is gathering evidence primarily in support of the assertion that
a) Recorded obligations were paid.
b) Incurred obligations were recorded in the correct period.
c) Recorded obligations were valid.
d) Cash disbursements were recorded as incurred obligations.

Answer A is incorrect because the items in the vouchers payable register recorded during the last month may or may not have been paid when an auditor is performing the audit.

Answer B is incorrect because the auditor is testing in the wrong direction to accomplish this objective. In order to support this assertion, the auditor would test from the source documents to the journal entries.

Answer C is correct. The requirement is to determine the assertion which is being tested when an auditor traces items for the last month from the vouchers payable register to the underlying documents. The existence of support for the recorded transactions will help the auditor to determine that the recorded obligations are valid.

Answer D is incorrect because to test whether cash disbursements are properly recorded an auditor would need to use the cash disbursements journal.

123. A client’s procurement system ends with the assumption of a liability and the eventual payment of the liability. Which of the following best describes the auditor’s primary concern with respect to liabilities resulting from the procurement system?
a) Accounts payable are not materially understated.
b) Authority to incur liabilities is restricted to one designed person.
c) Acquisition of materials is not made from one vendor or one group of vendor.
d) Commitments for all purchases are made only after established competitive bidding procedures are followed.

Answer A is correct because the auditor's concern with a client's procurement system is a possible understatement of the liabilities generated. By their nature, accounts payable may be understated due to nonrecording.

Answer B is incorrect because the authority to incur liabilities may be allocated to specific departments in need of goods.

Answer C is incorrect because the acquisition of materials may, in fact, be restricted to one group of vendors due to quality control specifications.

Answer D is incorrect because competitive bidding procedures may not be necessary for all purchases.

124. An examination of the balance in the accounts payable account is ordinarily not designed to
a) Detect accounts payable which are substantially past due.
b) Verify that accounts payable were properly authorized.
c) Ascertain the reasonableness of recorded liabilities.
d) Determine that all existing liabilities at the balance sheet date have been recorded.

Answer A is incorrect. It is an objective of the examination because the firm makes assertions as to the appropriate presentation and disclosure of such liabilities.

Answer B is correct. The requirement is to determine the statement that is not an objective of the examination of the balance in the accounts payable account. Proper authorization is an internal control principle that an auditor examines by compliance testing. Proper authorization only suggests that related account balances are more likely to be correct. Based on this reliance the auditor adjusts his/her substantive tests of account balances accordingly. Additionally, account balances may be correct whether they are properly authorized or not.

Answer C is incorrect. It is an objective of the examination because the reasonableness of recorded liabilities pertains to the existence assertion.

Answer D is incorrect. It is an objective of the examination, since determining that all existing liabilities are recorded pertains to the completeness assertion.

125. An auditor’s purpose in reviewing the renewal of a note payable shortly after the balance sheet date most likely is to obtain evidence concerning management’s assertions about
a) Existence or occurrence.

b) Presentation and disclosure.
c) Completeness.
d) Valuation or allocation.

Answer A is incorrect because the existence or occurrence of the debt is not in question.

Answer B is correct. The requirement is to identify the assertion to which the renewal of a note payable shortly after the balance sheet date relates to most directly. The renewal of the note may provide an auditor with information on whether the note should be presented as a current or noncurrent liability.

Answer C is incorrect because the procedure deals with debt of which the auditor is already aware and therefore completeness is not at issue.

Answer D is incorrect because the valuation of notes payable is generally at the amount of the debt.

126. During an examination of a publicly held company, the auditor should obtain written confirmation regarding debenture transactions from the
a) Debenture holders.
b) Client’s attorney.
c) Internal auditors.
d) Trustee.

Answer A is incorrect because debenture holders will generally be able to confirm only balances (as opposed to transactions) at any one point in time.

Answer B is incorrect. The client's attorney does not generally maintain detailed transaction records pertaining to debentures.

Answer C is incorrect. Internal auditors will in general have no more detailed information on the debentures than that already available to the auditor from the firm being audited. Also, internal auditors provide internally generated evidence which is not in general considered as reliable as externally generated evidence.

Answer D is correct. The requirement is to determine from whom the auditor should obtain written confirmation for debenture transactions of a publicly held company. Firms will almost always utilize the services of an independent trustee when debentures are outstanding. The trustee will maintain records on the bond transactions during the year.

127. Several years ago Conway, Inc. secured a conventional real estate mortgage loan. Which of the following audit procedures would be least likely to be performed by an auditor examining the mortgage balance?
a) Examine the current year’s cancelled checks.
b) Review the mortgage amortization schedule.
c) Inspect public records of lien balances.
d) Recompute mortgage interest expense.

Answer A is incorrect because the examination of canceled checks should be performed by the auditor in order to provide evidence that payments have been made.

Answer B is incorrect because an auditor should review the mortgage amortization schedule in order to obtain information as to the portions of payments representing principal (reduction of mortgage balance) and interest.

Answer C is correct because it is unlikely that public records can provide relevant information about the current mortgage balance and, therefore, this procedure is the least likely to be performed by an auditor.

Answer D is incorrect because recomputing interest expense will allow the auditor to determine the portions of the payments representing principal (reduction of mortgage balance) and interest.

128. Two months before the year-end the bookkeeper erroneously recorded the receipt of a long-term bank loan by a debit to cash and a credit to sales. Which of the following is the most effective procedure for detecting this type of error?

a) Analyze the notes payable journal.
b) Analyze bank confirmation information.
c) Prepare a year-end bank reconciliation.
d) Prepare a year-end bank transfer schedule.

Answer A is incorrect because the credit to sales indicates that the loan has not been recorded in the notes payable journal.

Answer B is correct because the standard bank confirmation form requests information on outstanding bank loans. Evidence of a loan outstanding from the confirmation with no corresponding liability on the client's books would lead the auditor to question the client's accounting for the transaction.

Answer C is incorrect because the year-end bank reconciliation pertains to the last month of the year, not to a period two months prior to year-end.

Answer D is incorrect because the year-end bank transfer schedule only includes transactions shortly before and after year-end. Additionally, the bank transfer schedule would not include the proceeds from the bank loan as no transfer between client bank accounts has occurred.

129. Three-R Corporation acquired a building and arranged mortgage financing during the year. Verification of the related mortgage acquisition costs would be least likely to include an examination of the related

a) Deed.
b) Cancelled checks.
c) Closing statement.
d) Interest expense.

Answer A is correct because deeds generally consist of a legal conveyance of rights to use real property. Frequently the sales price is not even specified and the related mortgage acquisition costs are much less likely to be stated in the deed.

Answer B is incorrect because canceled checks would provide verification of mortgage acquisition costs.

Answer C is incorrect because the closing statement would provide a detailed listing of the costs of acquiring the real property, including possible mortgage acquisition costs.

Answer D is incorrect because examination of interest expense would relate to the mortgage acquisition costs.

130. An auditor’s program for the examination of long-term debt should include steps that require the

a) Inspection of the accounts payable subsidiary ledger.
b) Investigation of credits to the bond interest income account.
c) Verification of the existence of the bondholders.
d) Examination of any bond trust indenture.

Answer A is incorrect because the accounts payable subsidiary ledger does not relate directly to long-term debt.

Answer B is incorrect because bond interest income relates to investments, not to long-term debt.

Answer C is incorrect because auditors often do not verify (through use of confirmations or otherwise) the existence of bondholders.

Answer D is correct. The requirement is to identify the most likely required steps in an auditor's program for the examination of long-term debt. The bond trust indenture will generally include loan information which will affect both financial statement presentation and accompanying disclosures.

131. During the year under audit, a company has completed a private placement of a substantial amount of bonds. Which of the following is the most important step in the auditor’s program for the examination of bonds payable?

a) Confirming the amount issued with the bond trustee.
b) Tracing the cash received from the issue to the accounting records.
c) Examining the bond records maintained by the transfer agent.
d) Recomputing the annual interest cost and the effective yield.

Answer A is incorrect because a bond trustee would not be used for a private placement.

Answer B is correct because the most important procedure is to trace the amount of cash received to the accounting records. The auditor's concern is that all of the cash that was supposed to be received was properly received and accounted for.

Answer C is incorrect because determining who holds the bonds is of much less concern to the auditor than the amount and proper recording of the issue.

Answer D is incorrect because the auditor's primary concern is with the proper recording of the bond issue, not with the computation of interest expense.

132. In connection with the audit of a current issue of long-term bonds payable, the auditor should
a) Determine whether bondholders are persons other then owners, directors, or officers of the company issuing the bond.
b) Calculate the effective interest rate to see if it is substantially the same as the rates for similar issues.
c) Decide whether the bond issue was made without violating state or local law.
d) Ascertain that the client has obtain the opinion of counsel on the legally of the issue.

Answer A is incorrect because long-term bonds payable may be, and often are, held by owners, directors, or officers of the issuing company.

Answer B is incorrect because the auditor would calculate the effective rate of interest to verify that the proper amount of interest had been expensed during the period, not for comparison with other debt issues.

Answer C is incorrect because the auditor must rely on the opinion of client legal counsel as to the legality of the issue. The auditor alone may not make this judgment.

Answer D is correct because the auditor is concerned with the legality of an issue of bonds, and should obtain an opinion of legal counsel.

133. The auditor can best verify a client's bond sinking fund transactions and year-end balance by
a) Confirmation with the bond trustee.
b) Confirmation with individual holders of retired bonds.
c) Recomputation of interest expense, interest payable, and amortization of bond discount or premium.
d) Examination and count of the bonds retired during the year.

Answer A is correct because the best verification of a client's bond sinking fund transactions and year-end balance is confirmation with the bond trustee. The bond trustee is an independent party and accordingly can provide valid evidence.

Answer B is incorrect because the individual holders of the retired bonds would not even collectively have knowledge of all possible bond sinking fund transactions, much less the year-end balance.

Answer C is incorrect because amortization of bond discount or premium would have no effect on bond sinking fund transactions even if bond interest were being paid by the sinking fund (which is usually not the case).

Answer D is incorrect because an examination and count of the bonds retired during the year would not verify the transactions (e.g., how much was paid to the bond) and would give no indication of the year-end balance in the fund. The year-end balance is cumulative over all the transactions from the inception of the fund.

134. Which of the following is the most important consideration of an auditor when examining the stockholders' equity section of a client's balance sheet?
a) Changes in the capital stock account are verified by an independent stock transfer agent.
b) Stock dividends and/or stock splits during the year under audit were approved by the stockholders.
c) Stock dividends are capitalized at par or stated value on the dividend declaration date.
d) Entries in the capital stock account can be traced to resolution in the minutes of the board of directors' meeting.

Answer A is incorrect because the independent stock transfer agent does not verify changes in the capital stock account; the transfer agent merely maintains the capital stock subsidiary ledger which details holdings of the stock. For nonpublic companies, the client would likely maintain the stockholder records themselves, not employing a transfer agent.

Answer B is incorrect because stock dividends and/or stock splits generally do not require approval by the stockholders.

Answer C is incorrect because stock dividends are normally capitalized at market value on the dividend declaration date. Note an exception exists for closely-held companies where par or stated value may be capitalized.

Answer D is correct because the auditor's primary concern when examining the stockholders' equity section of the balance sheet is that proper authorization exists for transactions affecting the capital stock account.

135. An audit program for the examination of the retained earnings account should include a step that requires verification of the
a) Market value used to change retained earnings to account for two-for-one stock split.
b) Approval of the adjustment to the beginning balance as a result of a write-down of an account receivable.
c) Authorization for both cash and stock dividends.
d) Gain or loss resulting from disposition of treasury shares.

Answer A is incorrect because only a memo entry is required for a stock split. Retained earnings would not be affected by a two-for-one stock split.

Answer B is incorrect because the write-down of an account receivable will not, in general, be recorded in retained earnings.

Answer C is correct because the legality of a dividend depends in part on whether it has been properly authorized (state laws differ on specific requirements). Thus, the auditor must determine that proper authorization exists, as both cash and stock dividends affect retained earnings.

Answer D is incorrect because gains from the disposition of treasury shares are recorded in paid-in capital accounts.

136. In the audit of a medium sized manufacturing concern, which one of the following areas would be expected to require the least amount of audit time?

a) Owners' equity.
b) Revenue.
c) Assets.
d) Liabilities.

Answer A is correct because the number of transactions affecting owners' equity are few in number relative to transactions affecting revenue, assets, and liabilities. Generally only dividend payments, sales of stock, treasury stock transactions, and stock dividends affect owners' equity. Thus, all owners' equity transactions can be verified in relatively little time.

Answer B is incorrect because a great number of transactions affect revenue. Testing this large number of transactions would require a great deal of audit time.

Answer C is incorrect because a large number of transactions affect assets. To test these transactions, a great deal of audit time would be needed.

Answer D is incorrect because many transactions affect liabilities. Thus, testing a large number of transactions will require a significant amount of audit time.

137. During an audit of an entity's stockholders' equity accounts, the auditor determines whether there are restrictions on retained earnings resulting from loans, agreements, or state law. This audit procedure most likely is intended to verify management's assertion of

a) Existence or occurrence.
b) Completeness.
c) Valuation or allocation.
d) Presentation and disclosure.

Answer A is incorrect. The existence or occurrence assertion addresses whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period.

Answer B is incorrect. The completeness assertion addresses whether all transactions and accounts that should be presented in the financial statements are so included.

Answer C is incorrect. The valuation or allocation assertion addresses whether asset, liability, revenue, and expense components have been included in the financial statements at appropriate amounts.

Answer D is correct. Such restrictions will result in note disclosures and thus the presentation and disclosure assertion is most directly being verified.

138. Preliminary arrangements agreed to by the auditor and the client should be reduced to writing by the auditor. The best place to set forth these arrangements is in

a) A memorandum to be placed in the permanent section of the auditing working papers.
b) An engagement letter.
c) A client representation letter.
d) A confirmation letter attached to the constructive services letter.

Answer A is incorrect because the current engagement letter should appear in the current file section of the working papers. In addition, the written agreement should be in the form of an engagement letter rather than merely a memorandum.

Answer B is correct because the engagement letter provides written confirmation of the arrangements agreed to by the auditor and the client. The engagement letter should contain a description of the accounting services to be rendered, the limitations of an audit in detecting fraud, the fee arrangements, etc.

Answer C is incorrect because a client representation letter is obtained from the client during the course of the audit as a form of audit evidence, not as a means of confirming preliminary agreements.

Answer D is incorrect because a constructive services letter (management letter) is sent to the client at the end of the audit, to make constructive suggestions to the client concerning possible improvements in client operations and recordkeeping.

139. "There have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements." The foregoing passage is most likely from a

a) a special report.
b) Management representation letter.
c) Letter for an underwriter.
d) Report on internal controls.

Answer A is incorrect because the statement is not included in a special report.

Answer B is correct. The requirement is to identify the source of a statement indicating that "there have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have material effect on the financial statements." AU 333 requires that the auditor obtain such a statement in the management representation letter.

Answer C is incorrect because the statement is not included in a letter for an underwriter.

Answer D is incorrect because the statement is not included in a report on internal controls.

140. If management refuses to furnish certain written representations that the auditor believes are essential, which of the following is appropriate?

a) The auditor can rely on oral evidence relating to the matter as a basis for an unqualified opinion.

b) The client's refusal does not constitute a scope limitation that may lead to a modification of the opinion.

c) This may have an effect on the auditor's ability to rely on other representations of management.

d) The auditor should issue an adverse opinion because of management's refusal.

Answer A is incorrect because the written evidence is considered necessary.

Answer B is incorrect because such refusal does constitute a scope limitation. Refer to the correct answer explanation.

Answer C is correct because management's refusal to furnish such written representations constitutes a scope limitation which is sufficient to preclude an unqualified opinion. In addition, the auditor should consider whether s/he can rely on other representations of management.

Answer D is incorrect because the auditor is not in a position to evaluate whether specific information lacking is correct or incorrect. Accordingly, a qualified opinion or a disclaimer would be appropriate.

141. An auditor should obtain written representations from management concerning litigation claims and assessments. These representations may be limited to matters that are considered either individually or collectively material, provided an understanding on the limits of materiality for this purpose has been reached by

a) The auditor and client's lawyer.

b) Management and the auditor.

c) Management, the client's lawyer, and the auditor.

d) The auditor independently of management.

Answer A is incorrect. The client's lawyer is not directly involved in the decision.

Answer B is correct. The requirement is to identify the parties which determine the limits of materiality for statements made in the representation letter. Materiality is to be determined by management and the auditor. The client's lawyer only becomes involved when an inquiry has been directed to him/her.

Answer C is incorrect. The client's lawyer is not directly involved in the decision.

Answer D is incorrect because the auditor and management jointly arrive at materiality limits.

142. Because of the pervasive effects of laws and regulations on the financial statements of governmental units, an auditor should obtain written management representations acknowledging that management has

a) Implemented internal control policies and procedures designed to detect all illegal acts.

b) Documented the procedures performed to evaluate the governmental unit's compliance with law and regulations.

c) Identified and disclosed all laws and regulation that have a direct and material effect on its financial statements.
d) Reported all known illegal acts and material weakness in internal control structure to the funding agency or regulatory body.

Answer A is incorrect because the obtaining of such representations is not suggested by AU 801.

Answer B is incorrect because the obtaining of such representations is not suggested by AU 801.

Answer C is correct. The requirement is to identify the additional written management representations from management that an auditor should consider obtaining when performing audits of governmental units. AU 801 states that the auditor should consider obtaining representations from management that it has identified and disclosed to the auditor all laws and regulations that have a direct and material effect on the determination of financial statement amounts. The section also suggests obtaining a representation that management is responsible for the entity's compliance with laws and regulations applicable to it.

Answer D is incorrect because the obtaining of such representations is not suggested by AU 801.

143. Which of the following statements ordinarily is included among the written client representations obtained by the auditor?
a) Management acknowledges that there are no material weaknesses in the internal controls.
b) Sufficient evidential matter has been made available to permit the issuance of an unqualified opinion.
c) Compensating balances and other arrangement involving restrictions on cash balances have been disclosed.
d) Management acknowledges responsibility for illegal actions committed by employees.

Answer A is incorrect because management need not acknowledge that there are no material weaknesses in the internal control.

Answer B is incorrect because the client will not normally be in a position to make an affirmative statement on whether sufficient evidential matter has been made available.

Answer C is correct. The requirement is to identify the information ordinarily included among the written client representations obtained by the auditor. AU 333 includes information on compensating balances and other cash balance restrictions as items for which the auditor ordinarily obtains written representations.

Answer D is incorrect because management need not acknowledge responsibility for illegal actions committed by employees.

144. To which of the following matters would an auditor not apply materiality limits when obtaining specific written client representations?
a) Disclosure of compensating balances arrangements involving restrictions on cash balances.
b) Information concerning related-party transactions and related amounts receivable or payable.

c) The absence of errors and unrecorded transactions in the financial statements.
d) Fraud involving employees with significant roles in the internal control structure.

Answer A is incorrect because compensating balance arrangements need only be disclosed when they are material to the financial statements.

Answer B is incorrect because related-party transactions need only be disclosed when they are material to the financial statements.

Answer C is incorrect because an audit must be designed to provide reasonable assurance of detecting errors and fraud that are material to the financial statements.

Answer D is correct. The requirement is to determine the matter an auditor would not apply materiality limits to when obtaining specific written client representations. AU 333 requires that a materiality limit not apply to fraud involving management or employees who have significant roles in internal control.

145. Tin accepted an engagement to audit the 2005 Financial statements of CPA Company. CPA completed the preparation of the 2005 financial statements on February 23, 2006, and Tin began the fieldwork on February 27, 2006. Hall completed the fieldwork on March 24, 2006, and completed the report on March 28, 2006. The client's representation letter normally would be dated
a) February 23, 2006.
b) February 27, 2006.
c) March 24, 2006.
d) March 28, 2006

Answer A is incorrect. Refer to the correct answer explanation.

Answer B is incorrect. Refer to the correct answer explanation.

Answer C is correct because the auditor's report is dated the last day of significant fieldwork, March 24, 2006, in this case.

Answer D is incorrect. Refer to the correct answer explanation.

146. The date of the management representation letter should coincide with the
a) Date of the auditor's report.
b) Balance sheet date.
c) Date of the latest subsequent event referred to in the notes to the financial statements.
d) Date of the engagement agreement.

Answer A is correct because the representation letter should be dated as of the date of the auditor's report.

Answer B is incorrect. Refer to the correct answer explanation.

Answer C is incorrect. Refer to the correct answer explanation.

Answer D is incorrect. Refer to the correct answer explanation.

147. A written representation from a client's management which, among other matters, acknowledges responsibility for the fair presentation of financial statements, should normally be signed by the

a) Chief executive officer and the chief financial officer.
b) Chief financial officer and the chairman of the board of directors.
c) Chairman of the audit committee of the board of directors.
d) Chief executive officer, the chairman of the board of directors, and the client's lawyer.

Answer A is correct because AU 333 states that, normally, the chief executive officer and the chief financial officers should sign the letter of representations. These are the individuals who the auditor believes are responsible for and knowledgeable about the matters covered by the representations.

Answer B is incorrect. Refer to the correct answer explanation.

Answer C is incorrect. Refer to the correct answer explanation.

Answer D is incorrect. Refer to the correct answer explanation.

148. The auditor may refer to and identify a specialist in the auditor's report if the auditor

a) Expresses an unqualified opinion.
b) Believes it will facilitate an understanding of the reason for modification of the report.
c) Wishes to indicate a division of responsibility.
d) Wishes to emphasize the thoroughness of the audit.

Answer A is incorrect because the expression of an unqualified opinion should not refer to the findings of the specialist, as this may be construed as a qualification of the opinion or a division of responsibility.

Answer B is correct because such reference is appropriate only when a report modification is being made as a result of the report or findings of the specialist.

Answer C is incorrect because a division of responsibility (as defined in the standards) involves other auditors, not a specialist.

Answer D is incorrect because the thoroughness of the audit is not expressed in such a manner. The thoroughness of the audit is determined by whether the examination was made in accordance with GAAS as referred to in the scope paragraph.

149. When an outside specialist has assumed full responsibility for taking the client's physical inventory, reliance on the specialist's report is acceptable if

a) The auditor is satisfied through the application procedures as to the reputation and competence of the specialist.

b) Circumstances made it impracticable or impossible for the auditor either to do work personally or observe the work done by the inventory firm.
c) The auditor conducted the same audit tests and procedures as would have been applicable if the client employees took the physical inventory.
d) The auditor's report contains a reference to the assumption of full responsibility.

Answer A is incorrect because even if the reputation and competence of the specialist have been evaluated, some test counts will be necessary.

Answer B is incorrect because the auditor is required to make or observe some physical counts of the inventory, recompute calculations of the submitted inventory on a test basis, and conduct tests to the intervening transactions.

Answer C is correct because when a CPA has conducted the same tests as s/he would have if client employees had taken the inventory, sufficient evidence will normally have been collected. In fact, in many such circumstances the CPA may reduce the extent of his/her work.

Answer D is incorrect because ordinarily, the audit report need not refer to the specialist. Also, the auditor must be responsible for the amount of inventory and may not delegate that responsibility by a reference in the report.

150. In which of the following instances would an auditor be least likely to require the assistance of a specialist?
a) Assessing the valuation of inventories of art works.
b) Determining the quantities of materials stored in piles on the ground.
c) Determining the assessed valuation of fixed assets.

Answer A is incorrect because the assistance of a specialist may be required to assess the valuation of inventories of art works.

Answer B is incorrect because the assistance of a specialist may be necessary to determine the quantities of materials stored in piles on the ground.

Answer C is incorrect because the assistance of a specialist may be required to determine the value of unlisted securities.

Answer D is correct because it is unlikely that an auditor will be concerned with the assessed valuation of fixed assets. Historical cost of fixed assets would be of audit interest and generally available.

151. Which of the following is not a specialist upon whose work an auditor may rely?
a) Actuary.
b) Appraiser.
c) Internal auditor.
d) Engineer.

Answer A is incorrect because an actuary is an example of a specialist.

Answer B is incorrect because an appraiser is an example of a specialist.

Answer C is correct because the professional standards relating to the work of a specialist do not apply to the work of an internal auditor.

Answer D is incorrect because an engineer is an example of a specialist.

152. In using the work of a specialist, an understanding should exist among the auditor, the client, and the specialist as to the nature of the work to be performed by the specialist. Preferably, the understanding should be documented and would include all of the following except

a) The objectives and scope of the specialist’s work.
b) The specialist representation as to his relationship, if any to the client.
c) The specialist’s understanding of the auditor’s corroborative use of the specialist’s finding in relation to the representations in the financial statements.
d) Statements that the methods or assumptions to be use are not inconsistent with those used by the client.

Answer A is incorrect. AU 336 suggests documentation of the specialist's objectives and scope.

Answer B is incorrect. AU 336 suggests documentation of the relationship of the specialist (if any) to the client.

Answer C is incorrect. AU 336 suggests documentation of an understanding of the auditor's use of the specialist's findings.

Answer D is correct. The requirement is to determine the information which need not be documented when an auditor uses the work of a specialist. The assumptions used by a specialist in certain circumstances may be inconsistent with those used by the client.

153. The auditor’s primary means of obtaining corroboration of management’s information concerning litigation is a

a) Letter of audit inquiry to the client’s lawyer.
b) Letter of corroboration from the auditor’s lawyer upon review of the legal documentation.
c) Confirmation of claims and assessments from the other parties to the litigation.
d) Confirmation of claims and assessments from an officer of the court presiding over the litigation.

Answer A is correct because a letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.

Answer B is incorrect because the auditor's lawyer does not write such a "letter of corroboration."

Answer C is incorrect because the auditor does not generally confirm claims and assessments from the other parties to the litigation.

Answer D is incorrect because the auditor does not generally confirm claims and assessments from an officer of the court.

154. An attorney responding to an auditor as a result of the client's letter of audit inquiry may appropriately limit the response to

a) Items which have high probability of being resolved to the client's detriment.

b) Asserted claims and pending or threatened litigation.

c) Legal matters subject to unsettled points of law, uncorroborated information, or other complex judgments.

d) Matters to which the attorney has given substantive attention in the form of legal consultation or representation.

Answer A is incorrect because the attorney must reply to matters, regardless of whether the probable resolution will be detrimental to the client.

Answer B is incorrect because, in addition to replying to asserted claims and pending litigation, the attorney is obligated to reply to questions about unasserted claims and assessments.

Answer C is incorrect because the attorney is not exempt from responding to legal matters subject to unsettled points of law, uncorroborated information, or other complex judgments.

Answer D is correct. The requirement is to identify the appropriate limitation for an attorney's response to a client's letter of audit inquiry. AU 337 states that an attorney may appropriately limit his response to matters to which he has given substantive attention in the form of legal consultation or representation.

155. An auditor would be most likely to identify a contingent liability by obtaining a(n)

a) Accounts payable confirmations.

b) Transfer agent confirmation.

c) Standard bank confirmation.

d) Related-party transaction confirmation.

Answer A is incorrect because while it is possible that an accounts payable confirmation might identify a contingent liability, the information requested is generally related to the actual liability as of year-end.

Answer B is incorrect because a confirmation sent to a transfer agent provides more evidence on the number of shares issued and outstanding.

Answer C is correct because the standard bank confirmation directly requests information on contingent liabilities.

Answer D is incorrect because auditors do not in general send "related-party transaction" confirmations.

156. An auditor will ordinarily examine invoices from lawyers primarily in order to

a) Substantive accrual.

b) Assess the legal ramification of litigation in progress.
c) Estimate the dollar amount of contingent liabilities.
d) Identify possible unasserted litigation, claims, and assessments.

Answer A is incorrect because such accruals are typically of a lesser concern than the litigation, claims, and assessments.

Answer B is incorrect because legal ramifications will be obtained primarily through use of lawyers' letters and through discussions with management.

Answer C is incorrect because estimates of contingent liabilities will be obtained primarily through use of lawyers' letters and through discussions with management.

Answer D is correct. The requirement is to determine the primary reason auditors examine invoices from lawyers. An auditor may learn of litigation, claims, and assessments on which an attorney has worked when the attorney lists them on an invoice.

157. An auditor should obtain evidential matter relevant to all the following factors concerning third-party litigation against a client except the
a) Period in which the underlying cause of legal action occurred.
b) Probability of an unfavorable outcome.
c) Jurisdiction in which the matter will be resolved.
d) Existence of a situation indicating an uncertainty as to the possible loss.

Answer A is incorrect. Information on the period in which the underlying cause occurred should be obtained.

Answer B is incorrect. Information on the probability of an unfavorable outcome should be obtained.

Answer C is correct. The requirement is to identify the type of evidential matter that is not generally relevant to third-party litigation against a client. Answer C is least relevant because in most cases such jurisdictional information will not be considered.

Answer D is incorrect. Information on the existence of a condition indicating an uncertainty as to possible loss should be obtained.

158. Auditors should request than an audit send a letter of inquiry to those attorneys who have been consulted concerning litigation, claims, or assessments. The primary reason for this request is to provide
a) Information concerning the progress of cases to date.
b) Corroborative evidential matter.
c) An estimate of the peso amount of the probable loss.
d) An expert opinion as to whether a loss is possible, probable, or remote.

Answer A is incorrect because the client, and not the attorney, is the primary source of information concerning the progress of cases to date.

Answer B is correct because AU 337 states that a letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.

Answer C is incorrect because often it will not be possible for the attorney to estimate the peso amount or the likelihood of loss.

Answer D is incorrect because often it will not be possible for the attorney to estimate the dollar amount or the likelihood of loss.

159. A CPA has received an attorney's letter in which no significant disagreements with the client's assessments of contingent liabilities were noted. The resignation of the client's lawyer shortly after receipt of the letter should alert the auditor that

a) Undisclosed unasserted claims may have arisen.
b) The attorney was unable to form a conclusion with respect to the significance of litigation, claims, and assessments.
c) The auditor must begin a completely new examination of contingent liabilities.
d) An adverse opinion will be necessary.

Answer A is correct. The auditor is concerned with obtaining from the client's lawyer corroborating evidence concerning information furnished by management regarding litigation, claims, and assessments. The resignation of the client's lawyer may indicate the development of a conflict between the client and the lawyer regarding undisclosed unasserted claims. Accordingly, the auditor should inquire as to the nature of the lawyer's resignation.

Answer B is incorrect because the attorney issued a letter indicating no significant disagreements with the client's assessment of contingent liabilities.

Answer C is incorrect because the auditor should consider the need for further inquiry but need not begin a completely new examination of contingent liabilities.

Answer D is incorrect because the auditor should consider the need for further inquiry but need not issue an adverse opinion.

160. A lawyer's response to an auditor's request for information concerning litigation, claims, and assessments will ordinarily contain which of the following?

a) An explanation regarding limitations on the scope of the response.
b) A statement of concurrence with the client's determination of which unasserted possible claims warrant specification.
c) Confidential information which would be prejudicial to the client's defense if publicized.
d) An assertion that the list of unasserted possible claims identified by the client represent all such claims of which the lawyer may be aware.

Answer A is correct because a lawyer's response will ordinarily contain an explanation of the limitations on the scope of the response. The lawyer will appropriately limit the response to matters which he has given substantive attention to, and to matters that are considered material to the financial statements. These limitations are not limitations on the scope of the auditor's examination.

Answer B is incorrect because the lawyer will not provide a statement of concurrence with the client's determination of which unasserted claims warrant specification.

Answer C is incorrect because there is no reason to believe that a lawyer's response will ordinarily include confidential information prejudicial to the client's defense, although this may possibly occur.

Answer D is incorrect because a lawyer will not state that the list of unasserted claims is complete.

161. The letter of audit inquiry addressed to the client’s legal counsel will not ordinarily be
a) Sent lawyer who was engaged by the audit client during the year and soon thereafter resigned the engagement.
b) A source of corroboration of the information originally obtained from management concerning litigation, claims, and assessments.
c) Limited to reference concerning only pending or threatened litigation with respect to which the lawyer has been engaged.
d) Needed during the audit of client whose securities are not registered with the SEC.

Answer A is incorrect because such an inquiry will be sent to the attorney regardless of whether he has resigned.

Answer B is incorrect because such a letter is the auditor's primary means of obtaining corroboration of the information originally obtained from management concerning litigations, claims, and assessments.

Answer C is correct because the letter of audit inquiry will not be limited to references concerning only pending or threatened litigation. Such a letter will seek information on claims, litigation, assessments, and unasserted claims, as well as on pending or threatened litigation.

Answer D is incorrect because such a letter is used for both SEC and non-SEC reporting firms.

162. Which of the following most likely would indicate the existence of related parties?
a) Writing down obsolete inventory just before year-end.
b) Failing to correct previously identified internal control deficiencies.
c) Depending on a single product for the success of the entity.
d) Borrowing money at an interest rate significantly below the market rate.

Answer A is incorrect. It represents a business situation that is less likely to indicate the existence of related parties.

Answer B is incorrect. It represents a business situation that is less likely to indicate the existence of related parties.

Answer C is incorrect. It represents a business situation that is less likely to indicate the existence of related parties.

Answer D is correct. The requirement is to identify the situation that might indicate the existence of related parties. One would not expect an unrelated entity to loan money at an interest rate significantly below the market rate.

163. An auditor searching for related-party transactions should obtain an understanding of each subsidiary’s relationship to the total entity because

a) This may permit the audit of intercompany account balances to the performed as of current dates.

b) Intercompany transactions may have been consummated on terms equipment to arm’s-length transactions.

c) This may reveal whether particular transactions would have taken place if the parties had not been related.

d) The business structure may be deliberately designed to obscure related-party transactions.

Answer A is incorrect because performing the audit of intercompany account balances concurrently with the search for related-party transactions in general is not necessary.

Answer B is incorrect because entering into intercompany transactions on terms equivalent to arm's-length transactions is not considered a problem. The auditor should obtain such an understanding so that he may determine whether related-party transactions may have been consummated on terms not equivalent to arm's-length transactions.

Answer C is incorrect because the auditor in general will not be able to determine whether particular transactions would have taken place if the parties had not been related.

Answer D is correct because experience has shown that business structure and operating style are occasionally deliberately designed to obscure related-party transactions.

164. After identifying related-party transactions, an auditor most likely would

a) Substantiate that the transactions were consummated on terms equivalent to those prevailing in arm-length transactions.

b) Discuss the implications of the transactions with third parties, such as the entity’s attorney and bankers.

c) Determine whether the transactions would have occurred if the parties has not been related.

Answer A is incorrect because it will often not be possible to substantiate whether the transactions were consummated on terms equivalent to those prevailing in arm's-length transactions.

Answer B is incorrect because it may not be necessary to discuss the implications of the information with attorneys and bankers.

Answer C is correct because an auditor will attempt to determine whether the transactions have been approved by the board of directors or other appropriate officials. See AU 334 for this and other procedures to be followed.

Answer D is incorrect because, except for routine transactions, it will not in general be possible to ascertain whether the transactions would have occurred if the parties had not been related.

165. After discovering that a related-party transaction exists, the auditor should be aware that the
a) Substance of the transaction could be significantly different from its form.
b) Adequacy of disclosure of the transaction is secondary to its legal form.
c) Transaction is assumed to be outside the ordinary course of business.
d) Financial statements should recognize the legal form of the transaction rather than its substance.

Answer A is correct. The auditor should be aware that for related-party transactions, the substance of a particular transaction may differ significantly from its form, and that the financial statements should recognize the substance rather than merely its legal form.

Answer B is incorrect. AU 334 states that the auditor should view related-party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure rather than the legal form.

Answer C is incorrect. AU 334 states that, in the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business.

Answer D is incorrect. AU 334 states that financial statements should recognize the substance of particular transactions rather than merely their legal form.

166. Which of the audit procedures listed below would be least likely to disclose the existence of related-party transactions of a client during the period under audit?
a) Reading “conflict-of-interest” statements obtained by the client from its management.
b) Scanning accounting records for large transactions at or just prior to the end of the period under audit.
c) Inspecting invoices from law firms.
d) Confirming large purchase and sales transactions with the vendors and/or customers involved.

Answer A is incorrect because reading "conflict-of-interest" statements is a procedure recommended in AU 334 for identifying material transactions with related parties.

Answer B is incorrect because scanning accounting records for large transactions at or just prior to year-end is an audit procedure recommended in AU 334 for identifying material transactions with related parties.

Answer C is incorrect because inspecting invoices from law firms is an audit procedure recommended by AU 334 for identifying material related-party transactions.

Answer D is correct because the confirmation of large purchase and sales transactions by itself will generally not disclose related-party transactions.

167. An independent auditor finds that a corporation occupies office space, at no charge, in an office building owned by a shareholder. This finding indicates the existence of
a) Management fraud.
b) Related-party transactions.
c) Window dressing.
d) Weak internal control.

Answer A is incorrect because there is no reason to believe that such a situation is the result of management fraud.

Answer B is correct because relationships with principal shareholders of this nature are considered related-party transactions.

Answer C is incorrect because window dressing deals with a deliberate attempt to overstate a company's financial position.

Answer D is incorrect because such an agreement may have little if anything to do with the firm's internal control structure.

168. When auditing related-party transactions, an auditor places primary emphasis on
a) Confirming the existence of the related parties.
b) Verifying the valuation of the related-party transactions.
c) Evaluating the disclosure of the related-party transactions.
d) Ascertaining the rights and obligations of the related parties.

Answer A is incorrect because while auditors attempt to determine the existence of related parties, this is not the primary emphasis.

Answer B is incorrect because verifying the valuation of related-party transactions will often not be possible.

Answer C is correct because the auditor should view related-party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure.

Answer D is incorrect because ascertaining rights and obligations is only part of the total responsibility.

169. An example of a transaction which may be indicative of the existence of related parties is
a) Borrowing or lending at a rate of interest which equals the current market rate.
b) Selling real estate at a price that is comparable to its appraised value.
c) Making large loans with specified terms as to when or how the funds will be repaid.
d) Exchanging properly for similar properly in a nonmonetary transaction.

Answer A is incorrect because borrowing or lending at the current market rate is indicative of an arm's-length transaction and does not suggest a related-party transaction.

Answer B is incorrect because selling property at a price that compares to its appraised value suggests an arm's-length transaction and not a related-party transaction.

Answer C is incorrect because making large loans with specified terms as to when or how funds will be repaid is indicative of an arm's-length transaction. An arm's-length transaction would not suggest the existence of related parties.

Answer D is correct because exchanging property for similar property in a nonmonetary transaction may indicate the existence of related parties (the exchange may or may not approximate what would occur in an arm's-length transaction).

170. Which of the following audit procedures would most likely assist an auditor in identifying conditions and events that may indicate there could be substantial doubt about an entity's ability to continue as a going concern?
a) Review compliance with terms of debt agreements.
b) Confirmation of account receivable from principal customers.
c) Reconciliation of interest expense with debt outstanding.
d) Confirmation of bank balances.

Answer A is correct. A review of compliance with terms of debt and loan agreements is a procedure that may reveal conditions of noncompliance due to poor financial condition. See AU 341 for a list of procedures that may identify conditions and events that indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

Answer B is incorrect. Confirmation of accounts receivable from principal customers provides evidential matter concerning management assertions in the financial statements. Although accounts receivables indicate possible future cash inflows to the business, they do not indicate an entity's ability to continue as a going concern.

Answer C is incorrect. Reconciliation of interest expense with debt outstanding provides evidential matter concerning management assertions in the financial statements. It does not indicate an entity's ability to continue as a going concern.

Answer D is incorrect. Confirmation of bank balances provides evidential matter concerning management assertions in the financial statements. It does not indicate an entity's ability to continue as a going concern.

171. A client acquired 25% of its outstanding capital stock after year-end and prior to completion of the auditor's fieldwork. The auditor should
a) Advise management to adjust the balance sheet to reflect the acquisition.
b) Issue pro forma financial statements giving effect to the acquisition as if it had occurred at year-end.
c) Advise management to disclose the acquisition in the notes to the financial statements.

d) Disclose the acquisition in the opinion paragraph of the auditor's report.

Answer A is incorrect. Financial statement adjustment is appropriate only for Type 1 subsequent events. Type 1 events provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements.

Answer B is incorrect. The auditor does not issue financial statements of any kind for the client. Financial statements are the responsibility of management.

Answer C is correct. The transaction described is a Type 2 subsequent event. Type 2 events provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. Type 2 events do not require financial statement adjustment. However, these events may be disclosed to keep the financial statements from being misleading.

Answer D is incorrect. The opinion paragraph of the auditor's report should not be modified for a subsequent event. If the auditor wishes to emphasize an unusually important subsequent event, the information should be presented in a separate explanatory paragraph preceeding the opinion paragraph.

172. Which of the following procedures would an auditor most likely perform to obtain evidence about an entity's subsequent events?

a) Reconcile bank activity for the month after the balance sheet date with cash activity reflected in the accounting records.

b) Examine on a test basis the purchase invoices and receiving reports for several days after the inventory date.

c) Review the treasure's monthly reports on temporary investment owned, purchased, and sold.

d) Obtain a letter from the entity's attorney describing any pending litigationm unasserted claims, or loss contingencies.

Answer A is incorrect. Reconciliation of bank activity for the month after year-end is normally the responsibility of the client and is not included in AU 560. AU 560 establishes procedures for ascertaining the occurrence of subsequent events.

Answer B is incorrect. Examining purchase invoices and receiving reports for several days after the inventory date is primarily a cutoff test and is not used to identify subsequent events.

Answer C is incorrect. While reviewing the treasurer's monthly reports on temporary investments represents a possible procedure, it first assumes the existence of such a report. Second, this procedure is not included in the list of procedures designed to obtain evidence about subsequent events that is presented in AU 560.

Answer D is correct. AU 560 provides a detailed list of audit procedures that auditors perform to ascertain whether subsequent events require adjustment or disclosure in the financial statements. Answer D is correct because it is one of those procedures presented.

173. After issuance of the auditor's report, the auditor has no obligation to make any further inquiries with respect to audited financial statements covered by that report unless
a) A final resolution of a contingency that had resulted in a qualification of the auditor's report is made.
b) A development occurs that may affect the client's ability to continue as a going concern.
c) An investigation of the auditor's practice by a peer review committee ensues.
d) New information is discovered concerning undisclosed related-party transactions of the previously audited period.

Answer A is incorrect because the contingency had been considered during the audit and the report was qualified. An auditor has no obligation to make any further inquiry or perform any other auditing procedures with respect to the audited financial statements covered by his/her report, unless new information which may affect the report comes to his/her attention. In this case, it is unlikely that the new information regarding the loss contingency would affect the report since it had been qualified.

Answer B is incorrect because the development occurred after the report was issued. The auditor need not consider making further inquiries regarding information which comes to his/her attention unless it existed at the date of the report.

Answer C is incorrect because an investigation by a peer review committee will not necessarily result in further audit procedures. (See AU 390 for circumstances in which omitted procedures are discovered.)

Answer D is correct. The requirement is to identify a situation in which an auditor has an obligation to make further inquiries after issuance of an auditor's report on financial statements. When an auditor becomes aware of information which relates to financial statements previously reported on by him/her and which existed at the date of the report, but which was not known to the auditor at the date of the report, inquiries are required if the additional information is of such a nature and from such a source that s/he would have investigated it had it come to his/her attention during the examination.

174. Ajax Company's auditor concludes that the omission of an audit procedure considered necessary at the time of the prior audit impairs the auditor's present ability to support the previously expressed unqualified opinion. If the auditor believes there are stockholders currently relying on the opinion, the auditor should promptly
a) Notify the stockholders currently relying on the previously expressed unqualified opinion that they should not rely on it.
b) Advise management to disclose this development in its next interim report to the stockholders.
c) Advise management to revise the financial statements will full disclosure of the auditor's inability to support the unqualified opinion.
d) Undertake to apply the omitted procedure or alternate procedures that would provide a satisfactory basis for the opinion.

Answer A is incorrect because the auditor would only notify persons relying on the financial statements in a circumstance such as this when his/her attorney determines it to be an appropriate course of action. As a matter of practicality, this may be difficult if stockholders are numerous.

Answer B is incorrect because action needs to be taken immediately, and the auditor should not wait until release of interim financial statements.

Answer C is incorrect because there may or may not be a need to revise financial statements. However, the necessary information for this judgment is not available at this point.

Answer D is correct. The requirement is to determine the auditor's responsibility when s/he has concluded that (1) a necessary audit procedure has been omitted at the time of a prior examination, (2) it impairs the ability to support the previous opinion, and (3) there are stockholders relying upon the statements. AU 390 requires that the auditor promptly undertake to apply the omitted procedure or alternative procedures that would provide a satisfactory basis for the audit opinion.

175. An auditor concludes that a substantive auditing procedure considered necessary during the prior period's audit was omitted. Which of the following factors would most likely cause the auditor promptly to apply the omitted procedure?

a) There are on alternative procedures available to provide the same evidence as the omitted procedure.
b) The omission of the procedures impairs the auditor's present ability to support the previously expressed opinion.
c) The source documents needed to perform the omitted procedure are still available.
d) The auditor's opinion on the prior period's financial statements was unqualified.

Answer A is incorrect because the auditor first must believe that persons may be relying upon the statements before considering performing either the procedure or an alternative procedure.

Answer B is correct because if the auditor concludes that the omission of the procedure impairs his/her present ability to support a previously expressed opinion and the auditor believes that persons may be relying on the financial statements, the omitted procedure or alternative procedures should be applied to provide a satisfactory basis for the opinion.

Answer C is incorrect because existence of a source document is not used in deciding whether there is a need to perform a procedure. Note, however, that in certain circumstances the lack of source documents may lead to the performance of alternative procedures.

Answer D is incorrect because the type of report issued in the prior period does not determine the appropriate action to be taken when an omitted procedure has been discovered.

176. The primary objective of analytical procedures used in the final review stage of an audit is to

a) Obtain evidence from details tested to corroborate particular assertions.
b) Identify areas that represent specific risks relevant to the audit.
c) Assist the auditor in assessing the validity of the conclusions reached.
d) Satisfy doubts when questions arise about a client's ability to continue in existence.

Answer A is incorrect because analytical procedures do not obtain evidence from details tested in order to corroborate particular assertions.

Answer B is incorrect because analytical procedures performed to identify areas that represent specific risks relevant to the audit are performed in the planning stages of the audit.

Answer C is correct because AU 329 states that the purpose of applying analytical procedures during the final review is to assist the auditor in assessing the conclusions reached during the audit and in the evaluation of the overall financial statement presentation.

Answer D is incorrect because while analytical procedures may identify doubts about a client's ability to continue in existence, it is not the primary objective of such procedures.

177. Which of the following auditing procedures is ordinarily performed last?
a) Reading of the minutes of the directors' meetings.
b) Confirming accounts payable.
c) Obtaining a management representation letter.
d) Testing of the purchasing function.

Answer A is incorrect because the minutes will often reveal matters requiring further investigation and should, therefore, be read early in the engagement during the planning phase.

Answer B is incorrect because substantive tests and compliance tests are normally performed at an interim date or as of year-end with the results being subject to subsequent analytical review.

Answer C is correct. The requirement is to determine the audit procedure which is ordinarily performed last. A management representation letter should be received and dated as of the last day of fieldwork (the date of the auditor's report).

Answer D is incorrect because substantive and compliance tests are normally performed at an interim date or as of year-end with the results being subject to subsequent analytical review.

178. Prior to commencing the compilation of financial statements of a nonpublic entity, the accountant should
a) Perform analytical procedures sufficient to determine whether fluctuation among account balances appear reasonable.
b) Complete the preliminary phase of the consideration of the entity's internal control.
c) Verify that the financial information supplied by the entity agrees with the books of original entry.
d) Acquire knowledge of any specialized accounting principles and practices used in the entity's industry.

Answer A is incorrect. The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity when performing a compilation.

Answer B is incorrect. The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity when performing a compilation.

Answer C is incorrect. The accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity when performing a compilation.

Answer D is correct. The accountant should possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates that will enable him to compile financial statements that are appropriate in form for an entity operating in that industry.

179. When compiling a nonpublic entity's financial statements, an accountant would be least likely to

a) Perform analytical procedures designed to identify relationship that appear to be unusual.

b) Read the compiled financial statements and consider whether they appear to include adequate disclosure.

c) Omit substantially all of the disclosure required by generally accepted accounting principles.

d) Issue a compilation report on one or more, but not all, of the basic financial statements.

Answer A is correct because analytical procedures are not normally performed during a compilation.

Answer B is incorrect because an accountant who performs a compilation must read the compiled statements and consider whether they appear to include adequate disclosure.

Answer C is incorrect because a client may elect to omit substantially all disclosures required by generally accepted accounting principles.

Answer D is incorrect because one, more, or all statements may be compiled.

180. Before performing a review of a nonpublic entity's financial statements, an accountant should

a) Complete a series of inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions.

b) Apply analytical procedures to provide limited assurance that no material modifications should be made to the financial statements.

c) Obtain a sufficient level of knowledge of the accounting principles and practices of the industry in which the entity operates.

d) Inquire whether management has omitted substantially all of the disclosures required by generally accepted accounting.

Answer A is incorrect. Completing a series of inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions is an inquiry that should be performed during the review, not before it.

Answer B is incorrect. Analytical procedures are applied during a review, not before it. Further, they are designed to identify relationships and individual items that appear to be unusual.

Answer C is correct. The accountant should possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates. This requirement does not prevent an accountant from accepting a review engagement for an entity in an industry with which the accountant has no previous experience. It does, however, place upon the accountant a responsibility to obtain the required level of knowledge.

Answer D is incorrect. Inquiring whether management has omitted substantially all of the disclosures required by generally accepted accounting principles should be performed during a review, not before it.

181. When making a review of interim financial information the auditor’s work consists primarily of
a) Studying and evaluating limited amounts of document supporting the interim financial information.
b) Scanning and reviewing client-prepared, internal financial statements.
c) Making inquiries and performing analytical procedures concerning significant accounting matters.
d) Confirming and verifying significant account balances at the interim date.

Answer A is incorrect because interim reviews are not undertaken to express an opinion on the financial statements. Accordingly, tests of accounting records and other procedures to obtain corroborating evidential matter are generally not performed.

Answer B is incorrect because a review contemplates more than scanning and reviewing the client's financial statements.

Answer C is correct because a review of interim financial information consists primarily of inquiries and analytical procedures concerning significant accounting matters relating to the financial data being reported.

Answer D is incorrect because interim reviews are not undertaken to express an opinion on the financial statements. Accordingly, tests of accounting records and other procedures to obtain corroborating evidential matter are generally not performed

182. Which of the following procedures is not usually performed by the accountant in a review engagement of a nonpublic entity?
a) Communicating any material weaknesses discovered during the consideration of internal control.
b) Reading the financial statements to consider whether they conform with generally accepted accounting principles.
c) Writing an engagement letter to establish an understanding regarding the services to be performed.
d) Issuing a report stating that the review was performed in accordance with standard established by the BOA.

Answer A is correct. The requirement is to identify the correct statement regarding the procedure not usually performed by the accountant in a review engagement of a nonpublic entity. Reviews of a nonpublic company do not include a consideration of internal control.

Answer B is incorrect because reading of the financial statements is required.

Answer C is incorrect because the accountant should establish an understanding regarding the services to be performed in an engagement letter.

D. Answer D is incorrect because the report issued does state that a review was performed in accordance with standards established by the BOA.

183. Which of the following procedures is usually performed by the accountant in a review engagement of a nonpublic entity?
a) Sending a letter of inquiry to the entity's lawyer.
b) Comparing the financial statements for comparable prior periods.
c) Confirming a significant percentage of receivable by direct communication with debtors.
d) Communicating reportable conditions discovered during the study of the internal control.

Answer A is incorrect because a letter of inquiry to the entity's attorney is generally not required.

Answer B is correct. The requirement is to identify a procedure that is usually performed in a review engagement of a nonpublic entity. AR 100 provides a listing of procedures normally performed during review engagements. Comparing the financial statements with statements for comparable prior periods is among the procedures presented in AR 100.

Answer C is incorrect because confirmations are not generally used when performing a review.

Answer D is incorrect because a review of a nonpublic entity does not include a study of the internal control.

184. A typical objective of an operational audit is for the auditor to
a) Determine whether the financial statements fairly present the entity's operations.
b) Evaluate the feasibility of attaining the entity's operational objectives.
c) Make recommendation for improving performance.
d) Report on the entity's relative success in attaining profit maximization.

Answer A is incorrect because determining whether the financial statements fairly present the entity's operations is the objective of a financial statement audit.

Answer B is incorrect because evaluating the feasibility of attaining operational objectives is only a part of the objective of an operational audit. Refer to the correct answer explanation.

Answer C is correct. One of the objectives of operational audits is to develop recommendations for improving performance. Other objectives include assessing performance and identifying improvement opportunities.

Answer D is incorrect because operational auditing may involve developing recommendations to maximize profits but would not involve reporting on the entity's relative success in attaining such objectives.

185. Which of the following best describes the operational audit?
a) It requires the constant review by internal auditors of the administrative controls as they relate to the operations of the company.

b) It concentrates on implementing financial and accounting control in a newly organized company.
c) It attempts and is designed to verify the fair presentation of a company's results of operations.
d) It concentrates on seeking out aspects of operations in which waste would be reduced by the introduction of controls.

Answer A is incorrect because a constant review of administrative controls implies an ongoing analysis of operations, which describes the internal audit function.

Answer B is incorrect because the implementation of financial and accounting control is a basic management responsibility, not an operational audit objective.

Answer C is incorrect because the verification of fair presentation of the results of operations is the objective of a financial statement audit.

Answer D is correct because operational audits attempt to improve operations and reduce waste through the introduction of controls.