

CPA REVIEW SCHOOL OF THE PHILIPPINES

Manila

AUDITING THEORY

PROFESSIONAL AND LEGAL RESPONSIBILITIES

Related PSAs : PSA 240rev, 250 and 260

PSA 240(rev) – The Auditor's Responsibility to Consider Fraud and Error in the Audit of FS

1. The primary responsibility for the prevention and detection of fraud and error rests with
 - a. The auditor.
 - b. Those charged with governance.
 - c. The management of an entity.
 - d. Both b and c.
2. When planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should
 - a. Search for errors that would have a material effect and for fraud that would have either material or immaterial effect on the financial statements.
 - b. Consider the risk of misstatements in the financial statements resulting from fraud or error.
 - c. Search for fraud that would have a material effect and for errors that would have either material or immaterial effect on the financial statements.
 - d. Consider the risk of material misstatements in the financial statements resulting from fraud or error.
3. The following are examples of error, except
 - a. A mistake in gathering or processing data from which financial statements are prepared.
 - b. An incorrect accounting estimate arising from oversight or misinterpretation of facts.
 - c. A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
 - d. Misrepresentation in the financial statements of events, transactions or other significant information.
4. The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Which statement is correct regarding fraud?
 - a. Auditors make legal determinations of whether fraud has actually occurred.
 - b. Misstatement of the financial statements may not be the objective of some frauds.
 - c. Fraud involving one or more members of management or those charged with governance is referred to as "employee fraud".
 - d. Fraud involving only employees of the entity is referred to as "management fraud".
5. The types of intentional misstatements that are relevant to the auditor's consideration of fraud include
 - I. Misstatements resulting from fraudulent financial reporting
 - II. Misstatements resulting from misappropriation of assets
 - a. I and II
 - b. I only
 - c. II only
 - d. Neither I nor II
6. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting least likely involve
 - a. Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
 - b. Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
 - c. Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
 - d. Embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received.
7. Which of the following illustrates a perceived opportunity to commit fraud?
 - a. Individuals are living beyond their means.
 - b. Management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target.

- c. An individual believes internal control could be circumvented because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.
- d. All of the above.
8. Which statement is incorrect regarding the auditor's responsibility to consider fraud and error in an audit of financial statements?
- a. The auditor is not and cannot be held responsible for the prevention of fraud and error.
- b. In planning the audit, the auditor should discuss with other members of the audit team the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error.
- c. The auditor should design test of controls to reduce to an acceptably low level the risk that misstatements resulting from fraud and error that are material to the financial statements taken as a whole will not be detected.
- d. When the auditor encounters circumstances that may indicate that there is a material misstatement in the financial statements resulting from fraud or error, the auditor should perform procedures to determine whether the financial statements are materially misstated.
9. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because
- a. The effect of fraudulent act is likely omitted in the accounting records.
- b. Fraud is ordinarily accompanied by acts specifically designed to conceal its existence.
- c. Fraud is always a result of connivance between or among employees.
- d. The auditor is responsible to detect errors but not fraud.
10. Which of the following statements describes why a properly designed and executed audit may not detect a material fraud?
- a. Audit procedures that are effective for detecting an unintentional misstatement may be ineffective for an intentional misstatement that is concealed through collusion.
- b. An audit is designed to provide reasonable assurance of detecting material errors, but there is no similar responsibility concerning material fraud.
- c. The factors considered in assessing control risk indicated an increased risk of intentional misstatements, but only a low risk of unintentional errors in the financial statements.
- d. The auditor did not consider factors influencing audit risk for account balances that have pervasive effects on the financial statements taken as a whole.
11. The auditor's ability to detect a fraud depends on factors such as
- I. The skillfulness of the perpetrator.
- II. The frequency and extent of manipulation.
- III. The degree of collusion involved.
- IV. The relative size of individual amounts manipulated.
- V. The seniority of those involved.
- a. All of the above b. I, III and V only c. I, II, III and V only d. III and V only
12. In comparing management fraud with employee fraud, the auditor's risk of failing to discover the fraud is
- a. Greater for employee fraud because of the higher crime rate among blue collar workers.
- b. Greater for management fraud because of management's ability to override existing internal controls.
- c. Greater for employee fraud because of the larger number of employees in the organization.
- d. Greater for management fraud because managers are inherently smarter than employees.
13. The subsequent discovery of a material misstatement of the financial statements resulting from fraud or error, in and of itself, indicates:
- | | <u>a</u> | <u>b</u> | <u>c</u> | <u>d</u> |
|---|----------|----------|----------|----------|
| • a failure to obtain reasonable assurance | Yes | Yes | Yes | No |
| • inadequate planning, performance or judgment | Yes | No | No | No |
| • the absence of professional competence and due care | Yes | Yes | No | No |
| • a failure to comply with PSAs | Yes | No | No | No |

14. Whether the auditor has performed an audit in accordance with PSAs is determined by
 - a. The adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's report based on the result of these procedures.
 - b. The absence of material misstatements.
 - c. The absence of material errors.
 - d. The Securities and Exchange Commission.
15. When planning the audit, which of the following is least likely a purpose of the auditor's inquiries of management?
 - a. To obtain an understanding of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud.
 - b. To obtain knowledge of management's understanding regarding the accounting and internal control systems in place to prevent and detect error.
 - c. To determine whether management has discovered any material errors.
 - d. To determine extent of authentication of documentation.
16. Which of the following best describes what is meant by the term "fraud risk factor"?
 - a. Factors whose presence indicates that the risk of fraud is high.
 - b. Factors whose presence often has been observed in circumstances where frauds have occurred.
 - c. Factors whose presence requires modifications of planned audit procedures.
 - d. Reportable conditions identified during an audit.
17. Which of the following is least likely a category of fraud risk factors that relate to misstatements resulting from fraudulent financial reporting?
 - a. Management's characteristics and influence over the control environment.
 - b. Industry conditions.
 - c. Operating characteristics and financial stability.
 - d. Susceptibility of assets to misappropriation.
18. Fraud risk factors relating to management's characteristics and influence over the control environment
 - a. Pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.
 - b. Involve the economic and regulatory environment in which the entity operates.
 - c. Pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.
 - d. Involve the lack of controls designed to prevent or detect misappropriation of assets.
19. Which of the following is least likely an example of fraud risk factors relating to management's characteristics and influence over the control environment?
 - a. There is motivation for management to engage in fraudulent financial reporting.
 - b. There is a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.
 - c. Non-financial management participates excessively in, or is preoccupied with, the selection of accounting principles or the determination of significant estimates.
 - d. New accounting, statutory or regulatory requirements that could impair the financial stability or profitability of the entity.
20. The following are examples of fraud risk factors relating to industry conditions, except
 - a. There is a high turnover of management, counsel or board members.
 - b. A high degree of competition or market saturation, accompanied by declining margins.
 - c. A declining industry with increasing business failures and significant declines in customer demand.
 - d. Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.

21. Which of the following is most likely an example of fraud risk factor relating to management's characteristics and influence over the control environment?
- There is a strained relationship between management and the current or predecessor auditor.**
 - Inability to generate cash flows from operations while reporting earnings and earnings growth.
 - Significant related party transactions which are not in the ordinary course of business.
 - Significant, unusual or highly complex transactions (especially those close to year-end) that pose difficult questions concerning substance over form.
22. Examples of fraud risk factors relating to susceptibility of assets to misappropriation include the following, except
- Large amounts of cash on hand or processed.
 - Inventory characteristics, such as small size combined with high value and high demand.
 - Easily convertible assets, such as bearer bonds, diamonds or computer chips.
 - Lack of appropriate management oversight.**
23. Judgments about the risk of material misstatements resulting from fraud may affect the audit in the following ways, except
- The application of professional skepticism may include increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
 - The knowledge, skill and ability of members of the audit team assigned significant audit responsibilities need to be commensurate with the auditor's assessment of the level of risk for the engagement.
 - The auditor may decide to consider further management's selection and application of significant accounting policies, particularly those related to revenue recognition, asset valuation or capitalizing versus expensing.
 - The auditor's ability to assess control risk at high level may be reduced.**
24. The nature, timing and extent of procedures may need to be modified in the following ways as possible responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.
- The nature of audit procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information.
 - The timing of substantive procedures may need to be altered to be closer to, or at, year-end.
 - The extent of the procedures applied will need to reflect the assessment of the risk of material misstatement resulting from fraud.
 - All of the above.**
25. The auditor may encounter circumstances that, individually or in combination, indicate the possibility that the financial statements may contain a material misstatement resulting from fraud or error. These circumstances include the following, except
- Unrealistic time deadlines for audit completion imposed by management.
 - Conflicting or unsatisfactory evidence provided by management or employees.
 - Information provided unwillingly or after unreasonable delay.
 - Transactions recorded in accordance with management's general or specific authorization.**
26. Which of the following circumstances most likely indicate the possibility of fraud or error?
- Management engages in frank communication with appropriate third parties, such as regulators and bankers.
 - Evidence of an unduly lavish lifestyle by officers or employees.**
 - Conservative application of accounting principles.
 - Minimal differences from expectations disclosed by analytical procedures.
27. Which of the following should the auditor likely to do when the application of planned audit procedures indicates the possible existence of fraud or error?
- The auditor should resign in order to avoid legal responsibility.
 - He should discuss the matter with the person whom he believes is involved with the irregularities.
 - He should consider the potential effect on the financial statements.**
 - He should refer the suspected fraud or error to the internal auditor.

28. If the auditor believes an indicated fraud or error could have a material effect on the financial statements, the nature, timing and extent of the procedures to be performed depends on the auditor's judgment as to
 - a. The type of fraud or error.
 - b. The likelihood that a particular type of fraud or error could have a material effect on the financial statements.
 - c. The likelihood of their occurrence.
 - d. All of the above.
29. The auditor should document
 - a. Fraud risk factors identified as being present during the auditor's assessment process.
 - b. The auditor's response to fraud risk factors identified.
 - c. Both a and b.
 - d. Neither a nor b.
30. The auditor least likely obtains written representations from management that the management:
 - a. Acknowledges its responsibility for the implementation and operations of accounting and internal control systems that are designed to prevent and detect fraud and error.
 - b. Believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are material, both individually and in the aggregate, to the financial statements taken as a whole.
 - c. Has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity.
 - d. Has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
31. Communication of a misstatement resulting from fraud, or a suspected fraud, or error to the appropriate level of management on a timely basis is important because it enables management to take action as necessary. Ordinarily, the appropriate level of management is
 - a. At least equal to the level of the persons who appear to be involved with the misstatement or suspected fraud.
 - b. At least one level above the persons who appear to be involved with the misstatement or suspected fraud.
 - c. The audit committee of the board of directors.
 - d. The head of internal audit department.
32. The auditor may encounter exceptional circumstances that bring into question the auditor's ability to continue performing the audit, including where
 - a. The entity does not take the remedial action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements.
 - b. The auditor's consideration of the risk of material misstatement resulting from fraud and the results of audit tests indicate a significant risk of material and pervasive fraud.
 - c. The auditor has significant concern about the competence or integrity of management or those charged with governance.
 - d. All of the above.

PSA 250 – Consideration of Laws and Regulations in an Audit of Financial Statements

1. When an auditor becomes aware of a possible illegal act by a client, the auditor should obtain an understanding of the nature of the act to
 - a. Increase the assessed level of control risk.
 - b. Recommend remedial actions to the audit committee.
 - c. Evaluate the effect on the financial statements.
 - d. Determine the reliability of management's representations.

2. Mac, CPA, is auditing the financial statements of TL's Retailing, Inc. What assurance does Mac provide that direct effect illegal acts that are material to TL's financial statements, and illegal acts that have a material, indirect effect on the financial statements will be detected?
- | | <u>Direct effect illegal acts</u> | <u>Indirect effect illegal acts</u> |
|----|-----------------------------------|-------------------------------------|
| a. | Reasonable | None |
| b. | Reasonable | Reasonable |
| c. | Limited | None |
| d. | Limited | Reasonable |
3. The most likely explanation why the auditor's examination cannot reasonably be expected to bring all illegal acts by the client to the auditor's attention is that
- a. Illegal acts are perpetrated by management override of internal accounting controls.
 - b. Illegal acts by clients often relate to operating aspects rather than accounting aspects.
 - c. The client's system of internal accounting control may be so strong that the auditor performs only minimal substantive testing.
 - d. Illegal acts may be perpetrated by the only person in the client's organization with access to both assets and the accounting records.
4. An auditor who finds that the client has committed an illegal act would be most likely to withdraw from the engagement when the
- a. Illegal act affects auditor's ability to rely on management representations.
 - b. Illegal act has material financial statement implications.
 - c. Illegal act has received widespread publicity.
 - d. Auditor cannot reasonably estimate the effect of the illegal act on the financial statements.
5. If an auditor believes a client may have committed illegal acts, which of the following actions should the auditor take?
- a. Consult with the client's counsel and the auditor's counsel to determine how the suspected illegal acts will be communicated to stockholders.
 - b. Extend auditing procedures to determine whether the suspected illegal acts have a material effect on the financial statements.
 - c. Make inquiries of the client's management and obtain an understanding of the circumstances underlying the acts and of other evidence to determine the effects of the acts on the financial statements.
 - d. Notify each member of the audit committee of the board of directors about the nature of the acts and request that they advise an approach to be taken by the auditor.
6. An audit client's board of directors and audit committee refused to take action about an immaterial illegal act that was brought to their attention by the auditor. Because of their failure to act, the auditor withdrew from the engagement. The auditor's decision to withdraw was primarily due to doubt concerning
- a. Inadequate financial statement disclosures.
 - b. Compliance with the laws.
 - c. Scope limitations resulting from the inaction.
 - d. Reliance on management's representation.
7. Which of the following is incorrect about the auditor's responsibility of evaluating noncompliance by the entity to laws and regulations?
- a. An audit cannot be expected to detect noncompliance with all laws and regulations.
 - b. Noncompliance refers to acts of omission or commission by the entity being audited which are contrary to prevailing laws or regulations.
 - c. Noncompliance includes personal misconduct of entity management or employers though they are unrelated to the entity's business activities.
 - d. Detection of noncompliance, regardless of materiality, requires considerations of the implications for the integrity of management or employees.
8. What is expected of auditor in determining noncompliance by an entity to existing laws and regulations?
- a. Whether an act constitutes noncompliance is a legal determination that is ordinarily within the auditor's professional competence.
 - b. The auditor's training, experience and understanding of the entity and its industry cannot provide a basis for recognition that some acts coming to the auditor's attention may constitute noncompliance with laws and regulations.

- c. The determination as to whether a particular act constitutes or is likely to constitute noncompliance is generally based on the understanding of the auditor but ultimately can only be determined by an expert who is qualified to practice law.
 - d. In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with the framework.
9. When the auditor becomes aware of information concerning a possible noncompliance to laws or regulations, the auditor should appropriately:
 - a. Obtain an understanding of the nature of the act and the circumstances in which it has occurred, and evaluate the possible effect on the financial statements.
 - b. Discuss his suspicion with the management.
 - c. Ask management to determine whether a violation is really committed.
 - d. Consult with the entity's legal counsel as to what appropriate action the auditor should do.
 10. If the auditor suspects that members of senior management, including members of the board of directors, are involved in noncompliance to laws as regulations, and he believes his report may not be acted upon, he would:
 - a. Do nothing.
 - b. Issue a disclaimer of opinion.
 - c. Consider seeking legal advice.
 - d. Make special investigation in order to fully determine the extent of client's noncompliance.
 11. Which of the following circumstances regarding the entity's noncompliance to laws or regulations may cause the auditor to resign from an engagement?
 - a. The auditor is unable to determine whether noncompliance has occurred.
 - b. If the auditor concludes that the noncompliance has a material effect on the financial statements and has not been properly reflected in the financial statements.
 - c. When the entity does not take remedial action that he considers necessary in the circumstances even when the noncompliance is not material to financial statements.
 - d. When the disclosure of the effect of noncompliance to legal authority is necessary.
 12. Examples of the type of information that may come to the auditor's attention that may indicate that noncompliance with laws or regulations has occurred least likely include
 - a. Investigation by government departments or payment of fines or penalties.
 - b. Sales commissions or agent's fees that appear reasonable in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
 - c. Unusual transactions with companies registered in tax havens.
 - d. Media comment.

PSA 260 – Communications of Audit Matters with Those Charged with Governance

1. Which statement is incorrect regarding PSA 260?
 - a. The purpose of this PSA is to establish standards and provide guidance on communication of audit matters arising from the audit of financial statements between the auditor and those charged with governance of an entity.
 - b. These communications relate to audit matters of governance interest as defined in this PSA.
 - c. This PSA provides guidance on communications by the auditor to parties outside the entity, for example, external regulatory or supervisory agencies.
 - d. All the above statements are correct.
2. Which statement is incorrect regarding the auditor's communications of audit matters with those charged with governance?
 - a. The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity.
 - b. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties.
 - c. "Audit matters of governance interest" are those that arise from the audit of financial statements and, in the opinion of the auditor, are either important or relevant to those charged with governance in overseeing the financial reporting and disclosure process.
 - d. Audit matters of governance interest include only those matters that have come to the attention of the auditor as a result of the performance of the audit.

3. The role of persons entrusted with the supervision, control and direction of an entity
 - a. **Governance**
 - b. Board of directors
 - c. Government
 - d. Management
4. Which statement is correct regarding “audit matters of governance interest”?
 - a. These are matters that arise from the audit of financial statements and, in the opinion of the auditor, are either important or relevant to those charged with governance in overseeing the financial reporting and disclosure process.
 - b. **These include only those matters that have come to the attention of the auditor as a result of the performance of the audit.**
 - c. The auditor is required, in an audit in accordance with PSAs, to design procedures for the specific purpose of identifying these matters.
 - d. The auditor is not required to communicate these matters with those charged with governance of an entity.
5. Which statement is incorrect regarding the auditor’s communications of audit matters with those charged with governance?
 - a. **The auditor should communicate audit matters of governance interest upon completion of the engagement.**
 - b. The auditor’s communications with those charged with governance may be made orally or in writing.
 - c. When audit matters of governance interest are communicated orally, the auditor documents in the working papers the matters communicated and any responses to those matters.
 - d. Ordinarily, the auditor initially discusses audit matters of governance interest with management, except where those matters relate to questions of management competence or integrity.

Other Professional Responsibilities

1. An auditor’s overall objective in a financial statement audit is to
 - a. Determine that all individual accounts and footnotes are fairly presented.
 - b. Employ the audit risk model.
 - c. **Express an opinion on the fair presentation of the financial statements in accordance with generally accepted accounting principles.**
 - d. Detect all errors and fraud.
2. The primary responsibility for the adequacy of disclosure in the financial statements of a publicly held company rests with the
 - a. Partner assigned to the audit engagement.
 - b. **Management of the company.**
 - c. Auditor in-charge of field work.
 - d. Securities and Exchange Commission.
3. Reasonable assurance means:
 - a. Gathering of all available corroborating evidence for the auditor to conclude that there are no material misstatements in the financial statements, taken as a whole.
 - b. **Gathering of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements, taken as a whole.**
 - c. Gathering of the audit evidence necessary for the auditor to conclude that the financial statements, taken as a whole, are free from any misstatements.
 - d. Gathering of the audit evidence necessary for the auditor to conclude that the financial statements are free of material unintentional misstatements.
4. Which of the following ultimately determines the specific audit procedures necessary to provide an independent auditor with a reasonable basis for the expression of an opinion?
 - a. the audit program.
 - b. **the auditor’s judgment.**
 - c. generally accepted auditing standards.
 - d. the auditor’s working papers.
5. Which of the following best describes a trend in litigation involving CPAs?
 - a. A CPA cannot render an opinion on a company unless the CPA has audited all affiliates of that company.
 - b. A CPA may successfully assert as a defense that the CPA had no motive to be part of a fraud.
 - c. **A CPA may be exposed to criminal as well as civil liability.**

- d. A CPA is primarily responsible for a client's footnotes in an annual report filed with the SEC.
6. In performing MAS engagements, CPAs should not take any positions that might
- Constitute advice and assistance
 - Provide technical assistance in implementation
 - Result in new organizational policies and procedures
 - Impair their objectivity**
7. An audit independence issue might be raised by the auditor's participation in management advisory services engagements. Which of the following statements is most consistent with the profession's attitude toward this issue?
- Information obtained as a result of a management advisory services engagement is confidential to that specific engagement and should not influence performance of the attest function.
 - The decision as to loss of independence must be made by the client based upon the facts of the particular case.
 - The auditor should not make management decisions for an audit client.**
 - The auditor who is asked to review management decisions is also competent to make these decisions and can do so without loss of independence.
8. The form of communication with a client in a management advisory service consultation should be
- Either oral or written.**
 - Oral with appropriate documentation in the work papers.
 - Written and copies should be sent to both management and the board of directors.
 - Written and a copy should be sent to management alone.

Legal Responsibilities

1. Which one of the following, if present, would support a finding of constructive fraud on the part of a CPA?
- Privity of contract.
 - Reckless disregard.**
 - Intent to deceive.
 - Ordinary negligence.
2. The limitation of auditor liability under contract law is known as
- Privity of contract.**
 - Statutory liability.
 - Contributory liability.
 - Common law liability.
3. The auditor's defense of contributory negligence is most likely to prevail when
- Third party injury has been minimal.
 - The auditor fails to detect fraud resulting from management override of the control structure.**
 - The client is privately held as contrasted with a public company.
 - Undetected errors have resulted in materially misleading financial statements.
4. Mix and Associates, CPAs, issued an unqualified opinion on the financial statements of Glass Corp. for the year ended December 31, 2005. It was determined later that Glass' treasurer had embezzled P3,000,000 from Glass during 2005. Glass sued Mix because of Mix's failure to discover the embezzlement. Mix was unaware of the embezzlement. Which of the following is Mix's best defense?
- The audit was performed in accordance with GAAS.**
 - The treasurer was Glass' agent and, therefore, Glass was responsible for preventing the embezzlement.
 - The financial statements were presented in conformity with GAAP.
 - Mix had no actual knowledge of the embezzlement.
5. The factor that distinguishes constructive fraud from actual fraud is
- Materiality
 - Type of error or irregularity
 - Quality of internal control.
 - Intent.**
6. Working papers prepared by a CPA in connection with an audit engagement are owned by the CPA, subject to certain limitations. The rationale for this rule is to
- Protect the working papers from being subpoenaed.
 - Provide the basis for excluding admission of the working papers as evidence because of the privileged communication rule.

- c. Provide the CPA with evidence and documentation which may be helpful in the event of a lawsuit.
 - d. Establish a continuity of relationship with the client whereby indiscriminate replacement of CPAs is discouraged.
- 7. Mead Corp. orally engaged Dex & Co., CPAs, to audit its financial statements. The management of Mead informed Dex that it suspected that the accounts receivable were materially overstated. Although the financial statements audited by Dex did, in fact, include a materially overstated accounts receivable balance, Dex issued an unqualified opinion. Mead relied on the financial statements in deciding to obtain a loan from City Bank to expand its operations. City relied on the financial statements in making the loan to Mead. As a result of the overstated accounts receivable balance, Mead has defaulted on the loan and has incurred a substantial loss. If Mead sues Dex for negligence in failing to discover the overstatement, Dex's best defense would be that
 - a. No engagement letter had been signed by Dex.
 - b. The audit was performed by Dex in accordance with generally accepted auditing standards.
 - c. Dex was not in privity of contract with Mead.
 - d. Dex did not perform the audit recklessly or with an intent to deceive.
- 8. As a consequence of failure to adhere to generally accepted auditing standards in the course of an audit of the Lamp Corp., Harrison, CPA, did not detect the embezzlement of a material amount of funds by the company's controller. As a matter of common law, to what extent would Harrison be liable to the Lamp Corp. for losses attributable to the theft?
 - a. No liability since the ordinary examination cannot be relied on to detect defalcations.
 - b. No liability because privity of contract is lacking.
 - c. Liable for losses attributable to her or his negligence.
 - d. Liable only if it could be proved that he or she was grossly negligent.
- 9. Martin Corporation orally engaged Humm & Dawson to audit its year-end financial statements. The engagement was to be completed within two months after the close of Martin's fiscal year for a fixed fee of P250,000. Under these circumstances, what obligation is assumed by Humm & Dawson?
 - a. None. The contract is unenforceable since it is not in writing.
 - b. An implied promise to exercise reasonable standards of competence and care.
 - c. An implied obligation to take extraordinary steps to discover all defalcations.
 - d. The obligation of an insurer of its work, which is liable without fault.
- 10. In which of the following statements about a public accounting firm's action is scienter or its equivalent absent?
 - a. Reckless disregard for the truth.
 - b. Actual knowledge of fraud.
 - c. Intent to gain monetarily by concealing fraud.
 - d. Performance of substandard auditing procedures.
- 11. The leading precedent-setting auditing case in the third party liability is
 - a. Escott et al. v. Bar Chris Construction Corp.
 - b. Hochfelder v. Ernst & Ernst.
 - c. Ultramares Corporation v. Touche.
 - d. United States v. Simon.
- 12. The leading case of criminal action against CPAs is the
 - a. 1136 Tenants case.
 - b. United States v. Simon case, aka Continental Vending.
 - c. Escott et al. v. Bar Chris case, aka Bar Chris.
 - d. Ultramares Corporation v. Touche case.

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