

PART I: Multiple-Choice Questions (2 Points Each) Choose the **one best** response that you believe is most appropriate. (60%)

1. Which of the following statements reflects an auditor's responsibility for detecting errors and fraud?
 - a. An auditor is responsible for detecting employee errors and simple fraud, but **not** for discovering fraud involving employee collusion or management override.
 - b. An auditor should plan the audit to detect errors and fraud that are caused by departures from GAAP.
 - c. An auditor is **not** responsible for detecting errors and fraud unless the application of GAAS would result in such detection.
 - d. An auditor should design the audit to provide reasonable assurance of detecting errors and fraud that are material to the financial statements.
2. The audit procedure of analyzing the repairs and maintenance accounts is primarily designed to provide evidence in support of the audit proposition that all:
 - a. Noncapital expenditures have been properly expensed.
 - b. Expenditures for fixed assets have been capitalized.
 - c. Expenditures for fixed assets have been recorded in the proper period.
 - d. Capital expenditures have been properly authorized.
3. Analytical procedures reveal significant unexpected differences between recorded amounts and the expectations developed by the auditor. If management is unable to provide a satisfactory explanation, the auditor should:
 - a. Consider the matter a scope limitation.
 - b. Perform additional audit procedures to investigate the matter further.
 - c. Intensify the audit with the expectation of detecting management fraud.
 - d. Withdraw from the engagement.
4. When auditing related party transactions, an auditor places primary emphasis on:
 - a. Confirming the existence of related parties.
 - b. Verifying the valuation of related party transactions.
 - c. Evaluating the disclosure of the related party transactions.
 - d. Ascertaining the rights and obligations of the related parties.
5. Which of the following is generally correct about the competence of evidential matter?
 - a. The more effective the internal control structure, the more assurance it provides about the reliability of the accounting data and financial statements.
 - b. Competence of evidential matter refers to the amount of corroborative evidence obtained.
 - c. Information obtained indirectly from independent outside sources is more persuasive than the auditor's direct personal knowledge gained through physical examination and inspection.
 - d. Competence of evidential matter refers to the audit evidence obtained from outside the entity.
6. Which of the following types of evidence is the most persuasive?
 - a. Prenumbered client purchase order forms.
 - b. Client work sheets supporting cost allocations.
 - c. Bank statements obtained from the client.
 - d. Client representation letter from the client to the auditor.

7. Jones is auditing the financial statements of XYZ Retailing, Inc. What assurance does Jones provide that direct effect illegal acts that are material to XYZ's financial statements, and illegal acts that have a material, but indirect effect on the financial statements will be detected?
- | | Direct Effect | Indirect Effect |
|----|---------------------|---------------------|
| | <u>Illegal Acts</u> | <u>Illegal Acts</u> |
| a. | Reasonable | None |
| b. | Reasonable | Reasonable |
| c. | None | None |
| d. | Limited | Limited |
8. The auditor performs analytical procedures and discovers an unexplained increase in the gross margin percentage. A possible explanation for this is:
- A change in the sales mix in the current year such that a greater percentage of unit sales are low margin items.
 - Unrecorded inventory.
 - An increase in the unit cost of producing goods which was not passed along to the consumer.
 - Fictitious sales.
9. When considering the internal control structure, an auditor should be aware of the concept of reasonable assurance, which recognizes that
- Internal control policies and procedures may be ineffective due to mistakes in judgment and personal carelessness.
 - Adequate safeguards over access to assets and records should permit an entity to maintain proper accountability.
 - Establishing and maintaining the internal control structure is an important responsibility of management.
 - The cost of an entity's internal control structure should not exceed the benefits expected to be derived.
10. As the acceptable level of detection risk decreases, an auditor may
- Reduce substantive testing by relying on the assessments of inherent risk and control risk.
 - Postpone the planned timing of substantive tests from interim dates to the year-end.
 - Eliminate the assessed level of inherent risk from consideration as a planning factor.
 - Lower the assessed level of control risk from the maximum level to below the maximum.
11. In determining the sample size for a test of controls, an auditor should consider the likely rate of exceptions, the allowable risk of assessing control risk too low, and the
- Tolerable exception rate.
 - Risk of incorrect acceptance.
 - Nature and cause of exceptions.
 - Population size.

12. Cash receipts from sales on account have been misappropriated. Which of the following acts would conceal this defalcation and be **least** likely to be detected by an auditor?
- Understating the sales journal.
 - Overstating the accounts receivable control account.
 - Overstating the accounts receivable subsidiary ledger.
 - Understating the cash receipts journal.
13. The diagram below depicts an auditor's computed upper exception rate (CUER) compared with the tolerable exception rate (TER), and also depicts the true population exception rate compared with the tolerable exception rate.

Auditor's Estimate Based on Sample Results	True State of Population	
	Exception rate is less than tolerable exception rate	Exception rate exceeds tolerable exception rate
CUER is less than tolerable exception rate	I	III
CUER exceeds tolerable exception rate	II	IV

As a result of tests of controls, the auditor assesses control risk too high, and as a result unnecessarily increased substantive testing. This is illustrated by situation.

- I
 - II
 - III
 - IV
14. Samples to test internal control structure procedures are intended to provide a basis for the auditor to conclude whether:
- The control procedures are operating effectively.
 - The financial statements are materially misstated.
 - Materiality for planning purposes is at a sufficiently low level.
 - A reportable conditions letter should be issued.
15. Smith Manufacturing Company's accounts receivable clerk has a friend who is also a customer of Smith Manufacturing. The accounts receivable clerk, on occasion, has issued fictitious credit memorandums to his friend for errors in the quantity and prices of shipped goods, and other trade allowances. The most effective procedure for preventing this activity is to:
- Require internal verification of prices and quantities on sales invoices.
 - Require receiving reports to support all credit memorandums for returned goods.
 - Require approval of all credit memorandums and maintain control of prenumbered credit memorandums separate from accounts receivable.
 - Mail monthly statements to customers.
16. Tracing shipping documents to sales invoices provides evidence regarding:
- Existence of sales.
 - Completeness of sales.
 - Both existence and completeness of sales.
 - Neither the existence or completeness of sales.

17. The auditor decided to use non-statistical sampling to performs tests of transactions. Which of the following describes the auditor's sample selection?
- The auditor must use random selection.
 - The auditor must use judgmental selection.
 - The auditor may use either random or judgmental selection, but random selection is preferred.
 - The auditor may use either random or judgmental selection, but judgmental selection is preferred.
18. In testing for unrecorded retirements of equipment, an auditor most likely would:
- Select items of equipment from the accounting records and the locate them during the plant tour.
 - Compare depreciation journal entries with similar prior-year entries in search of fully depreciated equipment.
 - Inspect items of equipment observed during the plant tour and trace them to the equipment subsidiary ledger.
 - Scan the general journal for unusual equipment additions and excessive debits to repairs and maintenance expense.
19. To determine whether accounts payable are complete, an auditor performs a test to verify that all merchandise received is recorded. The population of documents for this test consists of all:
- Vendor's invoices.
 - Purchase orders.
 - Receiving reports.
 - Canceled checks.
20. An advantage of statistical sampling over nonstatistical sampling is that statistical sampling helps an auditor to:
- Minimize the failure to detect errors and irregularities.
 - Eliminate the risk of nonsampling errors.
 - Design more effective audit procedures.
 - Measure the sufficiency of evidential matter by quantifying sampling risk.
21. When obtaining an understanding of an entity's internal control procedures, an auditor should concentrate on the substance of procedures rather than their form because:
- The procedures may be operating effectively but may **not** be documented.
 - Management may establish appropriate procedures but **not** enforce compliance with them.
 - The procedures may be so inappropriate that **no** reliance is contemplated by the auditor.
 - Management may implement procedures whose costs exceeds their benefits.
22. Which of the following best illustrates the concept of sampling risk?
- The documents related to the chosen sample may not be available to the auditor for inspection.
 - An auditor may fail to recognize errors in the documents examined for the chosen sample.
 - An auditor may select audit procedures that are not appropriate to achieve the specific objective.
 - A randomly chosen sample may not be representative of the population as a whole on the characteristic of interest.

23. A company has computerized sales and cash receipt journals. The computer programs for these journals have been properly debugged. The auditor discovered that the total of the accounts receivable subsidiary accounts differs materially from the accounts receivable control account. This discrepancy could indicate:
- Credit memoranda being improperly recorded.
 - Theft of cash receipts in the mailroom.
 - Receivables not being properly aged.
 - Statements being intercepted prior to mailing.
24. To determine whether the internal control structure operated effectively to minimize errors of failure to invoice shipments, the auditor would select a sample of transactions from the population represented by:
- Customer order file.
 - Bill of lading file.
 - Accounts receivable master file.
 - Sales invoice file.
25. Reportable conditions are matters that come to an auditor's attention that should be communicated to an entity's audit committee because they represent:
- Manipulations or falsifications of accounting records or documents from which financial statements were prepared.
 - Material fraud or illegal acts perpetrated by high level management.
 - Material audit adjustments made by the auditor.
 - Significant deficiencies in the design of operation of the internal control structure.
26. Which of the following combinations results in a decrease in sample size in a sample for attributes?
- | | <i>Risk of assessing
control risk too low</i> | <i>Tolerable
rate</i> | <i>Expected population
deviation rate</i> |
|----|---------------------------------------------------|---------------------------|-----------------------------------------------|
| a. | Increase | Decrease | Increase |
| b. | Decrease | Increase | Decrease |
| c. | Increase | Increase | Decrease |
| d. | Increase | Increase | Increase |
27. Which of the following courses of action would an auditor most likely follow in planning a sample of cash disbursements if the auditor is aware of several unusually large cash disbursements?
- Set the tolerable rate of deviation at a lower level than originally planned.
 - Stratify the cash disbursements population so that the unusually large disbursements are selected.
 - Increase the sample size to reduce the effect of the unusually large disbursements.
 - Continue to draw new samples until all the unusually large disbursements appear in the sample.

28. Which of the following strategies would a CPA most likely consider in auditing an entity that processes most of its financial data only in electronic form, such as a paperless system?
- Continuous monitoring and analysis of transaction processing with an embedded audit module.
 - Increased reliance on internal control activities that emphasize the segregation of duties.
 - Verification of encrypted digital certificates used to monitor the authorization of transactions.
 - Extensive testing of firewall boundaries that restrict the recording of outside network traffic.
29. Which of the following activities most likely would detect whether payroll data were altered during processing?
- Monitor authorized distribution of data control sheets.
 - Use test data to verify the performance of edit routines.
 - Examine source documents for approval by supervisors.
 - Segregate duties between approval of hardware and software specifications.
30. When an auditor tests a computerized accounting system, which of the following is true of the test data approach?
- Several transactions of each type must be tested.
 - Test data are processed by the client's computer programs under the auditor's control.
 - Test data must consist of all possible valid and invalid conditions.
 - The program tested is different from the program used throughout the year by the client.

PART II: Problems (40%)

1. Green, CPA, has been engaged to audit the financial statements of Star Manufacturing, Inc. Star is a medium-sized entity that produces a wide variety of household goods. All acquisitions of materials are processed through the purchasing, receiving, accounts payable, and treasury functions.

Required:

Prepare the "Purchases" segment of the internal control questionnaire to be used in the evaluation of Star's internal control. Each question should elicit either a yes or no response. (20%)

2. Green, CPA, is auditing the financial statements of Taylor Corporation for the year ended December 31, 2001. Green plans to complete the fieldwork and sign the auditor's report about May 10, 2002. Green is concerned about events and transactions occurring after December 31, 2001 that may affect the 2002 financial statements.

Required:

What are the general types of subsequent events that require Green's consideration and evaluation? (10%)

3. Briefly describe what you know about the Enron scandal, and discuss what are the impacts on accounting profession. (10%)