

CPA PassMaster Questions–Auditing 1
Export Date: 10/30/08

Audited Financial Statements - The Basics

CPA-02320 Type1 M/C A-D Corr Ans: A PM#2 A 1-01

1. CPA-02320 Au Nov 93 #52 Page 58

Several sources of GAAP consulted by an auditor are in conflict as to the application of an accounting principle. Which of the following should the auditor consider the most authoritative?

- a. FASB Technical Bulletins.
- b. AICPA Accounting Interpretations.
- c. FASB Statements of Financial Accounting Concepts.
- d. AICPA Technical Practice Aids.

CPA-02320 Explanation

Choice "a" is correct. In accordance with the GAAP hierarchy, FASB Technical Bulletins are considered the most authoritative of the sources listed in the question.

Choice "b" is incorrect. Of the sources listed, AICPA Accounting Interpretations would be considered the second most authoritative.

Choice "c" is incorrect. FASB Statements of Financial Accounting Concepts are among the least authoritative sources of GAAP available to auditors.

Choice "d" is incorrect. AICPA Technical Practice Aids are among the least authoritative sources of GAAP available to auditors.

CPA-02325 Type1 M/C A-D Corr Ans: C PM#3 A 1-01

2. CPA-02325 Au Nov 91 #23 Page 3

For an entity's financial statements to be presented fairly in conformity with generally accepted accounting principles, the principles selected should:

- a. Be applied on a basis consistent with those followed in the prior year.
- b. Be approved by the Auditing Standards Board or the appropriate industry subcommittee.
- c. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
- d. Match the principles used by most other entities within the entity's particular industry.

CPA-02325 Explanation

Choice "c" is correct. Financial statements are presented fairly in conformity with GAAP when there are no material misstatements included therein. The fact that there may occasionally be immaterial misstatements means that the financial statements are correct "within a range of acceptable limits."

Choice "a" is incorrect. Accounting principles may change from year to year. As long as such changes are properly accounted for, the financial statements are still in conformity with GAAP.

Choice "b" is incorrect. The AICPA and the FASB determine GAAP, not the Auditing Standards Board.

Choice "d" is incorrect. There is no requirement that an entity's financial statements be prepared in accordance with prevalent industry practices in order to be in conformity with GAAP.

CPA-04613 Type1 M/C A-D Corr Ans: C PM#4 A 1-01

3. CPA-04613 Au R04 #8 Page 3

Which of the following statements is correct concerning an auditor's responsibilities regarding financial statements?

- a. An auditor may **not** draft an entity's financial statements based on information from management's accounting system.
- b. The adoption of sound accounting policies is an implicit part of an auditor's responsibilities.

- c. An auditor's responsibilities for audited financial statements are confined to the expression of the auditor's opinion.
- d. Making suggestions that are adopted about an entity's internal control environment impairs an auditor's independence.

CPA-04613 Explanation

Choice "c" is correct. An auditor's responsibility is to express an opinion on financial statements based on an audit.

Choice "a" is incorrect. An auditor may draft an entity's financial statements based on information from management's financial system. This would be referred to as a compilation engagement.

Choice "b" is incorrect. The adoption of sound accounting policies is an implicit part of management's responsibilities, not the auditor's responsibilities.

Choice "d" is incorrect. An auditor often makes suggestions that are adopted about an entity's internal control environment.

Professional Standards

CPA-02298 Type1 M/C A-D Corr Ans: C PM#1 A 1-02

4. CPA-02298 Au C02 #1A Page 6

Which of the following provides the most authoritative guidance for an auditor?

- a. An AICPA audit and accounting guide that provides specific guidance with respect to the accounting practices in the client's industry.
- b. A Journal of Accountancy article discussing implementation of a new standard.
- c. General guidance provided by a Statement on Auditing Standards.
- d. Specific guidance provided by an interpretation of a Statement on Auditing Standards.

CPA-02298 Explanation

Choice "c" is correct. General guidance provided by a Statement on Auditing Standards is the most authoritative of level of auditing guidance. Auditors are required to comply with SASs, and should be prepared to justify any departures therefrom.

Choices "a" and "d" are incorrect. AICPA audit and accounting guides and SAS interpretations are interpretive publications that provide guidance regarding how SASs should be applied in specific situations. They are not as authoritative as SASs.

Choice "b" is incorrect. Journal of Accountancy articles have no authoritative status but may be helpful to the auditor.

CPA-02299 Type1 M/C A-D Corr Ans: D PM#2 A 1-02

5. CPA-02299 Au C02 #2 Page 8

Which of the following accurately depicts the auditor's responsibility with respect to Statements on Auditing Standards?

- a. The auditor is required to follow the guidance provided by the Standards, without exception.
- b. The auditor is generally required to follow the guidance provided by Standards with which he or she is familiar, but will not be held responsible for departing from provisions of which he or she was unaware.
- c. The auditor is generally required to follow the guidance provided by the Standards, unless following such guidance would result in an audit that is not cost-effective.
- d. The auditor is generally required to follow the guidance provided by the Standards, and should be able to justify any departures.

CPA-02299 Explanation

Choice "d" is correct. The auditor is generally required to follow the guidance provided by the Standards, and should be able to justify any departures.

Choice "a" is incorrect. On rare occasions, the auditor may depart from the guidance provided by the SASs, but he or she must justify such departures.

Choice "b" is incorrect. Lack of familiarity with a SAS is not a valid reason for departing from its guidance. The auditor is expected to have sufficient knowledge of the SASs to identify those that are applicable to a given audit engagement.

Choice "c" is incorrect. The cost associated with following the guidance provided by a SAS is not an acceptable reason for departing from its guidance.

CPA-02309 Type1 M/C A-D Corr Ans: B PM#5 A 1-02

6. CPA-02309 Au Nov 95 #74 Page 11

In the first audit of a new client, an auditor was able to extend auditing procedures to gather sufficient evidence about consistency. Under these circumstances, the auditor should:

- a. Not report on the client's income statement.
- b. Not refer to consistency in the auditor's report.
- c. State that the consistency standard does not apply.
- d. State that the accounting principles have been applied consistently.

CPA-02309 Explanation

Choice "b" is correct. The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods. Since the auditor has gathered sufficient evidence about consistency, no reference need be made in the report.

Choice "a" is incorrect. If the auditor is able to obtain sufficient evidence about consistency, the auditor may report on the entity's financial statements.

Choice "c" is incorrect. The consistency standard is one of the ten GAAS, and it does apply to this audit.

Choice "d" is incorrect. If the auditor is able to obtain sufficient evidence about consistency, no mention of consistency need be made. Consistency is implied in the standard report.

CPA-02315 Type1 M/C A-D Corr Ans: D PM#6 A 1-02

7. CPA-02315 Au May 95 #23 Page 8

The third general standard states that due care is to be exercised in the performance of an audit. This standard is ordinarily interpreted to require:

- a. Thorough review of the existing safeguards over access to assets and records.
- b. Limited review of the indications of employee fraud and illegal acts.
- c. Objective review of the adequacy of the technical training and proficiency of firm personnel.
- d. Critical review of the judgment exercised at every level of supervision.

CPA-02315 Explanation

Choice "d" is correct. The third general standard of due care is ordinarily interpreted to require critical review of the judgment exercised at every level of supervision, and the judgment exercised by those assisting in the audit.

Choice "a" is incorrect. The third general standard of due care does not require a thorough review of the existing safeguards over access to assets and records.

Choice "b" is incorrect. The standard of due care does not specifically require a limited review of the indications of employee fraud and illegal acts.

Choice "c" is incorrect. The standard of due care does not require a review of audit staff training and proficiency.

CPA-02330 Type1 M/C A-D Corr Ans: C PM#7 A 1-02

8. CPA-02330 Au May 91 #52 Page 8

The concept of materiality would be least important to an auditor when considering the:

- a. Adequacy of disclosure of a client's illegal act.
- b. Discovery of weaknesses in a client's internal control.
- c. Effects of a direct financial interest in the client on the CPA's independence.
- d. Decision whether to use positive or negative confirmations of accounts receivable.

CPA-02330 Explanation

Choice "c" is correct. Any direct financial interest in a client impairs independence, even if it is immaterial.

Choice "a" is incorrect. A material illegal act may require disclosure in or adjustment to the financial statements, whereas an immaterial illegal act may not require disclosure.

Choice "b" is incorrect. A material weakness in internal control will affect the nature, timing, and extent of audit procedures, whereas an immaterial weakness in internal control may have little impact on the audit.

Choice "d" is incorrect. An auditor is likely to use positive confirmations for material accounts receivable, but may consider negative confirmations for immaterial receivable balances.

CPA-04640 Type1 M/C A-D Corr Ans: A PM#8 A 1-02

9. CPA-04640 Au C05 #1 Page 4

An auditor of a nonpublic company must conduct the audit in accordance with:

- I. ASB standards.
- II. PCAOB standards.
- a. I.
- b. Both I and II.
- c. Either I or II, but not both.
- d. II.

CPA-04640 Explanation

Choice "a" is correct. An auditor of a nonpublic company must conduct the audit in accordance with ASB standards.

Choice "b" is incorrect. An auditor of a nonpublic company is not required to conduct the audit in accordance with PCAOB standards.

Choice "c" is incorrect. While an auditor is only *required* to conduct the audit in accordance with ASB standards, the auditor may choose to follow PCAOB standards as well.

Choice "d" is incorrect. An auditor of a nonpublic company is not required to conduct the audit in accordance with PCAOB standards.

CPA-02800 Type1 M/C A-D Corr Ans: C PM#9 A 1-02

10. CPA-02800 Au May 94 #11 Page 9

Because of the risk of material misstatement, an audit of financial statements in accordance with generally accepted auditing standards should be planned and performed with an attitude of:

- a. Objective judgment.
- b. Independent integrity.

- c. Professional skepticism.
- d. Impartial conservatism.

CPA-02800 Explanation

Choice "c" is correct. The auditor should plan and perform the audit with an attitude of professional skepticism. This attitude includes a questioning mind and a critical assessment of audit evidence.

Choices "a", "b", and "d" are incorrect. Objectivity, independence, integrity, and impartiality are basic ethical characteristics and professional qualities embodied in the general standards.

CPA-02820 Type1 M/C A-D Corr Ans: C PM#10 A 1-02

11. CPA-02820C03 #15 Page 26

Which of the following is **not** an example of the application of professional skepticism?

- a. Designing additional auditing procedures to obtain more reliable evidence in support of a particular financial statement assertion.
- b. Obtaining corroboration of management's explanations through consultation with a specialist.
- c. Inquiring of prior year engagement personnel regarding their assessment of management's honesty and integrity.
- d. Using third party confirmations to provide support for management's representations.

CPA-02820 Explanation

Choice "c" is correct. The auditor should consider that fraud might occur regardless of any past experience with the entity. An assessment of management's honesty and integrity performed during the previous year would not necessarily be relevant to the current year's audit.

Choice "a" is incorrect. An auditor might apply professional skepticism by performing additional audit procedures designed to improve the reliability of evidence.

Choice "b" is incorrect. Corroborating management's explanations is an example of the application of professional skepticism, since the auditor is obtaining additional support rather than simply accepting the explanation as given.

Choice "d" is incorrect. Using third party confirmations to provide support for management's representations is an example of the application of professional skepticism, since the auditor is obtaining additional support rather than simply accepting the explanation as given.

CPA-05465 Type1 M/C A-D Corr Ans: C PM#11 A 1-02

12. CPA-05465Released 2007 Page 8

Which of the following categories is included in generally accepted auditing standards?

- a. Standards of review.
- b. Standards of planning.
- c. Standards of fieldwork.
- d. Standards of evidence.

CPA-05465 Explanation

Choice "c" is correct. Generally accepted auditing standards include three categories: general standards, standards of fieldwork, and standards of reporting.

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

Reports on Audited Financial Statements

CPA-02351 Type1 M/C A-D Corr Ans: B PM#1 A 1-03

13. CPA-02351Au R03 #10 Page 23

When qualifying an opinion because of an insufficiency of audit evidence, an auditor should refer to the situation in the:

	<u>Scope paragraph</u>	<u>Notes to the financial statements</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

CPA-02351 Explanation

Choice "b" is correct. When a qualified opinion is issued due to a lack of sufficient audit evidence, the lack of evidence should be disclosed in an explanatory paragraph before the opinion paragraph. Since insufficient evidence is a scope limitation, the scope paragraph should also be modified to refer to the limitation and to the explanatory paragraph that discusses it.

Choices "a" and "c" are incorrect. Management (and not the auditor) prepares the notes to the financial statements. The auditor therefore would not refer to this (or any other) situation in the notes to the financial statements.

Choice "d" is incorrect. The auditor does refer to the situation in the scope paragraph.

CPA-02360 Type1 M/C A-D Corr Ans: C PM#2 A 1-03

14. CPA-02360Au C02 #3 Page 23

When an auditor believes there is substantial doubt about the ability of an entity to continue as a going concern, all of the following should be included in the audit documentation, **except**:

- a. The conditions that gave rise to the substantial doubt.
- b. The auditor's conclusion about whether substantial doubt remains or is alleviated.
- c. Management's conclusion regarding whether substantial doubt remains or is alleviated.
- d. The effect of the auditor's conclusion on the auditor's report.

CPA-02360 Explanation

Choice "c" is correct. Whether substantial doubt remains or is alleviated is a judgment call made by the auditor, and there is no requirement to document management's opinion on the matter.

Choices "a", "b", and "d" are incorrect. When an auditor believes there is substantial doubt about the ability of an entity to continue as a going concern, the conditions that gave rise to the substantial doubt, the auditor's conclusion about whether substantial doubt remains or is alleviated, and the effect of the auditor's conclusion on the auditor's report should all be documented.

CPA-02366 Type1 M/C A-D Corr Ans: C PM#3 A 1-03

15. CPA-02366Au R02 #11 Page 23

After considering an entity's negative trends and financial difficulties, an auditor has substantial doubt about the entity's ability to continue as a going concern. The auditor's considerations relating to management's plans for dealing with the adverse effects of these conditions most likely would include management's plans to:

- a. Increase current dividend distributions.
- b. Reduce existing lines of credit.
- c. Increase ownership equity.
- d. Purchase assets formerly leased.

CPA-02366 Explanation

Choice "c" is correct. The auditor considers any of management's plans that might serve to mitigate the adverse effects of particular conditions and events. Typically, plans to increase ownership equity, to

borrow money, to restructure debt, to sell assets, and/or to reduce or delay expenditures might all be considered mitigating factors.

Choices "a", "b", and "d" are incorrect. Increasing dividend distributions, reducing lines of credit, and purchasing assets would not improve a weak cash flow situation.

CPA-02379 Type1 M/C A-D Corr Ans: B PM#6 A 1-03

16. CPA-02379Au R01 #17 Page 24

In which of the following situations would an auditor ordinarily choose between expressing a qualified opinion or an adverse opinion?

- a. The auditor did not observe the entity's physical inventory and is unable to become satisfied about its balance by other auditing procedures.
- b. Conditions that cause the auditor to have substantial doubt about the entity's ability to continue as a going concern are inadequately disclosed.
- c. There has been a change in accounting principles that has a material effect on the comparability of the entity's financial statements.
- d. The auditor is unable to apply necessary procedures concerning an investor's share of an investee's earnings recognized on the equity method.

CPA-02379 Explanation

Choice "b" is correct. Inadequate disclosure of the substantial doubt about an entity's ability to continue as a going concern is a departure from GAAP, resulting in either a qualified or adverse opinion.

Choices "a" and "d" are incorrect. Scope limitations result in either a qualified opinion or in a disclaimer of opinion, but not in an adverse opinion.

Choice "c" is incorrect. A change in accounting principle results in a modified unqualified report, as long as the change was accounted for properly.

CPA-02385 Type1 M/C A-D Corr Ans: B PM#7 A 1-03

17. CPA-02385Au R98 #13 Page 22

Which of the following conditions or events most likely would cause an auditor to have substantial doubt about an entity's ability to continue as a going concern?

- a. Significant related party transactions are pervasive.
- b. Usual trade credit from suppliers is denied.
- c. Arrearages in preferred stock dividends are paid.
- d. Restrictions on the disposal of principal assets are present.

CPA-02385 Explanation

Choice "b" is correct. Indications of possible financial difficulties, such as denial of usual trade credit from suppliers, may cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.

Choice "a" is incorrect. The existence of related parties and the occurrence of related party transactions do not indicate doubt about the entity's ability to continue as a going concern.

Choice "c" is incorrect. Payment of preferred stock dividends in arrears might very well indicate an improvement in the entity's financial situation. It is the lack of payment of preferred, cumulative dividends (a possible indication of financial difficulty) that might cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.

Choice "d" is incorrect. Restrictions on the disposal of assets might limit the options available to management as far as mitigating adverse conditions, but it would not in and of itself cause the auditor to have substantial doubt about an entity's ability to continue as a going concern.

CPA-02395 Type1 M/C A-D Corr Ans: A PM#9 A 1-03

18. CPA-02395Au R98 #15 Page 35

In the first audit of a client, an auditor was not able to gather sufficient evidence about the consistent application of accounting principles between the current and prior year, as well as the amounts of assets or liabilities at the beginning of the current year. This was due to the client's record retention policies. If the amounts in question could materially affect current operating results, the auditor would:

- a. Be unable to express an opinion on the current year's results of operations and cash flows.
- b. Express a qualified opinion on the financial statements because of a client-imposed scope limitation.
- c. Withdraw from the engagement and refuse to be associated with the financial statements.
- d. Specifically state that the financial statements are not comparable to the prior year due to an uncertainty.

CPA-02395 Explanation

Choice "a" is correct. Since the auditor was unable to gather sufficient evidence on the beginning balances of the balance sheet accounts, the auditor would be unable to express an opinion on the current year's results of operations and cash flows. The auditor could express an opinion on the statement of financial position.

Choice "b" is incorrect. Since the scope limitation could have a pervasive effect on the financial statements (affecting all assets and liabilities), a disclaimer of opinion (and not merely a qualified opinion) is required on the income statement and statement of cash flows. An opinion may be expressed on the year-end statement of financial position.

Choice "c" is incorrect. The auditor does not need to withdraw from the engagement and refuse to be associated with the financial statements.

Choice "d" is incorrect. An uncertainty does not exist. The auditor can express an opinion on one of the financial statements.

CPA-02398 Type1 M/C A-D Corr Ans: B PM#10 A 1-03

19. CPA-02398Au R97 #5 (Adapted) Page 20

Pell, CPA, decides to serve as principal auditor in the audit of the financial statements of Tech Consolidated, Inc. Smith, CPA, audits one of Tech's subsidiaries. In which situation(s) should Pell make reference to Smith's audit?

- I. Pell reviews Smith's audit documentation and assumes responsibility for Smith's work, but expresses a qualified opinion on Tech's financial statements.
 - II. Pell is unable to review Smith's audit documentation; however, Pell's inquiries indicate that Smith has an excellent reputation for professional competence and integrity.
- a. I only.
 - b. II only.
 - c. Both I and II.
 - d. Neither I nor II.

CPA-02398 Explanation

Choice "b" is correct. The principal auditor makes reference in the audit report to the work of the other auditor when the principal auditor is unable to review the other auditor's audit documentation. This is because the principal auditor will be unable to be satisfied concerning the work performed by the other auditor. Even though the other auditor has an excellent reputation, the principal auditor must see the work to be able to assume responsibility for it.

Choice "a" is incorrect. When the principal auditor decides to assume responsibility for the work of the other independent auditor, no reference is made to the work of the other auditor, regardless of the type of audit report expressed.

Choice "c" is incorrect. When the principal auditor decides to assume responsibility for the work of the other independent auditor, no reference is made to the work of the other auditor, regardless of the type of audit report expressed.

Choice "d" is incorrect. The principal auditor will make reference in the audit report to the work of the other auditor when the principal auditor is unable to review the other auditor's audit documentation. This is because the principal auditor will be unable to be satisfied concerning the work performed by the other auditor. Even though the other auditor has an excellent reputation, the principal auditor must see the work to be able to assume responsibility for it.

CPA-02424 Type1 M/C A-D Corr Ans: D PM#12 A 1-03

20. CPA-02424Au Nov 95 #59 Page 23

Cooper, CPA, believes there is substantial doubt about the ability of Zero Corp. to continue as a going concern for a reasonable period of time. In evaluating Zero's plans for dealing with the adverse effects of future conditions and events, Cooper most likely would consider, as a mitigating factor, Zero's plans to:

- a. Discuss with lenders the terms of all debt and loan agreements.
- b. Strengthen internal controls over cash disbursements.
- c. Purchase production facilities currently being leased from a related party.
- d. Postpone expenditures for research and development projects.

CPA-02424 Explanation

Choice "d" is correct. When assessing management's plans for dealing with the adverse effects of future conditions and events, mitigating factors would include:

1. The postponement of expenditures (including R&D),
2. Plans to dispose of assets,
3. Plans to borrow money or restructure debt,
4. Plans to increase ownership equity (sell stock).

Choice "a" is incorrect. Discussions with lenders regarding terms would not be a mitigating factor. Actual agreements regarding restructuring of debt or amendments to covenants would be required.

Choice "b" is incorrect. Strengthening internal controls over cash would not qualify as a management tactic to address going concern issues.

Choice "c" is incorrect. Purchasing facilities which are currently being leased would only further decrease cash flow.

CPA-02438 Type1 M/C A-D Corr Ans: C PM#13 A 1-03

21. CPA-02438Au Nov 95 #62 Page 14

Which of the following statements is a basic element of the auditor's standard report?

- a. The disclosures provide reasonable assurance that the financial statements are free of material misstatement.
- b. The auditor evaluated the overall internal control.
- c. An audit includes assessing significant estimates made by management.
- d. The financial statements are consistent with those of the prior period.

CPA-02438 Explanation

Choice "c" is correct. The auditor's standard audit report includes a statement that "An audit includes assessing...significant estimates made by management..."

Choice "a" is incorrect. The standard audit report does not state that disclosures provide reasonable assurance that the financial statements are free of material misstatement. The correct statement is: "...standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement."