Auditing and Assurance Services, 15e, Global Edition **(Arens)**
Chapter 3 Audit Reports

Learning Objective 3-1

1) An audit of historical financial statements most commonly includes the:
A) balance sheet, statement of retained earnings, and the statement of cash flows.
B) income statement, the statement of cash flows, and the statement of net working capital.
C) statement of cash flows, balance sheet, and the statement of retained earnings.
D) balance sheet, income statement, statement of cash flows, and the statement of changes in stockholders' equity.
Answer: D
Terms: Audit of historical financial statements
Diff: Moderate
Objective: LO 3-1
AACSB: Reflective thinking skills

2) Auditing standards require that the audit report must be titled and that the title must:
A) include the word "independent."
B) indicate if the auditor is a CPA.
C) indicate if the auditor is a proprietorship, partnership, or corporation.
D) indicate the type of audit opinion issued.
Answer: A
Terms: Auditing standards require audit report title
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

3) To emphasize the fact that the auditor is independent, a typical addressee of the audit report could be:
A)

Company Controller	Shareholders	Board of Directors
No	Yes	Yes

B)

Company Controller	Shareholders	Board of Directors
No	No	Yes

C)

Company Controller	Shareholders	Board of Directors
Yes	Yes	No

D)

Company Controller	Shareholders	Board of Directors
Yes	No	No

Answer: A
Terms: Audit report addressee
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

4) The auditor's responsibility section of the standard unqualified audit report states that the audit is designed to:
A) discover all errors and/or irregularities.
B) discover material errors and/or irregularities.
C) conform to generally accepted accounting principles.
D) obtain reasonable assurance whether the statements are free of material misstatement.
Answer: D
Terms: Scope paragraph of standard unqualified audit report states
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

5) The audit report date on a standard unqualified report indicates:
A) the last day of the fiscal period.
B) the date on which the financial statements were filed with the Securities and Exchange Commission.
C) the last date on which users may institute a lawsuit against either client or auditor.
D) the last day of the auditor's responsibility for the review of significant events that occurred after the date of the financial statements.
Answer: D
Terms: Audit report date on standard unqualified report
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

6) The standard audit report for non-public entities refers to GAAS and GAAP in which sections?
A)

GAAS	GAAP
Auditor's responsibility	Auditor's responsibility

B)

GAAS	GAAP
Auditor's responsibility	Introductory paragraph

C)

GAAS	GAAP
Management's responsibility and Opinion paragraph	Management's responsibility and Introductory paragraph

D)

GAAS	GAAP
Auditor's responsibility	Management's responsibility and Opinion paragraph

Answer: D
Terms: Standard unqualified audit report for non-public entities; GAAS and GAAP
Diff: Moderate
Objective: LO 3-1
AACSB: Reflective thinking skills

7) Which of the following is **not** explicitly stated in the standard unqualified audit report?
A) The financial statements are the responsibility of management.
B) The audit was conducted in accordance with generally accepted accounting principles.
C) The auditors believe that the audit evidence provides a reasonable basis for their opinion.
D) An audit includes assessing the accounting estimates used.
Answer: B
Terms: Standard unqualified audit report
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

8) The standard unqualified audit report for a non-public entity must:
A) have a report title that includes the word "CPA."
B) be addressed to the company's stockholders and creditors.
C) be dated.
D) include an explanatory paragraph.
Answer: C
Terms: Standard unqualified audit report for a non-public entity;eight parts of the report
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills
Topic: Public

9) The management's responsibility section of the standard audit report for a non-public company states that the financial statements are:
A) the responsibility of the auditor.
B) the responsibility of management.
C) the joint responsibility of management and the auditor.
D) none of the above.
Answer: B
Terms: Standard unqualified audit report for a non-public entity;eight parts of the report
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

10) The introductory paragraph of the standard audit report for a non-public company performs which functions?
I. It states the CPA has performed an audit.
II. It lists the financial statements being audited.
III. It states the financial statements are the responsibility of the auditor.
A) I and II
B) I and III
C) II and III
D) I, II and III
Answer: A
Terms: Introductory paragraph of standard audit report
Diff: Moderate
Objective: LO 3-1
AACSB: Reflective thinking skills

11) Which of the following statements are true for the audit report of a non-public entity?
I. The introductory paragraph states that management is responsible for the preparation and content of the financial statements.
II. The scope paragraph states that the auditor evaluates the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management.
A) I only
B) II only
C) I and II
D) Neither I nor II
Answer: B
Terms: Introductory paragraph and scope paragraph
Diff: Moderate
Objective: LO 3-1
AACSB: Reflective thinking skills

12) The auditor's responsibility section of the standard audit report states that the auditor is:
A) responsible for the financial statements and the opinion on them.
B) responsible for the financial statements.
C) responsible for the opinion on the financial statements.
D) jointly responsible for the financial statements with management.
Answer: C
Terms: Standard unqualified audit report for a non-public entity;eight parts of the report
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

13) If the balance sheet of a private company is dated December 31, 2011, the audit report is dated February 8, 2012, and both are released on February 15, 2012, this indicates that the auditor has searched for subsequent events that occurred up to:
A) December 31, 2011.
B) January 1, 2012.
C) February 8, 2012.
D) February 15, 2012.
Answer: C
Terms: Audit report subsequent event dating
Diff: Moderate
Objective: LO 3-1
AACSB: Reflective thinking skills

14) The appropriate audit report date for a standard nonqualified audit report for a non-public entity should be the:
A) date the financial statements are given to the Board of Directors.
B) date of the financial statements.
C) date the auditor completed the auditing procedures in the field.
D) 60 days after the date of the financial statements as required by the SEC.
Answer: C
Terms: Standard unqualified audit report for a non-public entity;eight parts of the report
Diff: Moderate
Objective: LO 3-1
AACSB: Reflective thinking skills

15) Most auditors believe that financial statements are "presented fairly" when the statements are in accordance with GAAP, and that it is also necessary to:
A) determine that they are not in violation of FASB statements.
B) examine the substance of transactions and balances for possible misinformation.
C) review the statements using the accounting principles promulgated by the SEC.
D) assure investors that net income reported this year will be exceeded in the future.
Answer: B
Terms: Financial statements are presented fairly in accordance with GAAP
Diff: Challenging
Objective: LO 3-1
AACSB: Reflective thinking skills

16) An audit report prepared by Garrett and Brown, CPAs, is provided below. The audit for the year ended December 31, 2012 was completed on March 1, 2013, and the report was issued to Javlin Corporation, a private company, on March 13, 2013. List any deficiencies in this report. Do not rewrite the report.

We have examined the accompanying financial statements of Dalton Corporation as of December 31, 2012. These financial statements are the responsibility of the company's management.

Management's Responsibility for the Financial Statements:

Management is responsible for the preparation and fair presentation of the financial statements in accordance with generally accepted auditing standards; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from all misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to give an opinion on these financial statements based on our audit. We conducted our audits in accordance with auditing standards generally accepted throughout the world.Those standards require that we plan and perform the audit to obtain absolute assurance about whether the financial statements are free of misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on management's judgment, including the assessment of the risks of material misstatement of the income statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the auditor's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies and the accuracy of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present accurately the financial position of Javlin Corporation as of December 31, 2012, in conformity with accounting principles generally accepted in the United States of America.

Garrett and Brown, CPAs

March, 2013

Answer: The audit report contains the following deficiencies:
- The report title is missing. The title must include the word *independent.*
- The audit report address is missing.The report should be addressed to shareholders and the board of directors.
- The introductory paragraph should refer to an "audit," not an "examination."
- The introductory paragraph should list the financial statements that were audited.
- The introductory paragraph refers to the wrong company.
- The introductory paragraph should not state that the financial statements are the responsibility of management. This belongs in the next section- management's responsibility.
- The management's responsibility section should state that the financial statements are in accordance with "accounting principles generally accepted in the Unites States of America" not in accordance with generally accepted auditing standards."
- The auditor's responsibility section should state that our responsibility is to "express" an opinion, not "give" an opinion.
- The auditor's responsibility section should state the audit was conducted in accordance with "auditing standards generally accepted in the United States of America", not "throughout the world."
- The auditor's responsibility section should state that the audit was planned and performed to obtain "reasonable" assurance, not "absolute "assurance.
- The auditor's responsibility section should state that the financial statements are free of "material misstatements," not simply "misstatement."
- The scope paragraph of the auditor's responsibility section should state that the procedures selected depend on the "auditor's" judgment, not "management's" judgment.
- The scope paragraph of the auditor's responsibility section should state risk of material misstatement in the "financial statements," not the "income statement."
- The scope paragraph of the auditor's responsibility section should state the auditor considers internal control relevant to *management's* preparation , not *the entity's* preparation.
- The scope paragraph of the auditor's responsibility section is missing the sentence "Accordingly, we express no such opinion." This should be placed right after the second sentence.
- The scope paragraph of the auditor's responsibility section should state " *reasonableness"* of significant accounting estimates," not "*accurate.*"
- The scope paragraph should contain the following phrase: "An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation."
- The auditor's opinion section should state that the financial statements present "*fairly, in all material respects,"* not present *accurately*.
- The auditor's opinion section should include "and the results of their operations and cash flows for the year then ended."
- The audit report should be dated March 1, 2013.

Terms: Audit report deficiencies
Diff: Challenging
Objective: LO 3-1
AACSB: Analytic skills

17) Describe the standard unqualified report to be issued for an audit of a private company. Begin by specifying the eight parts of the report, and then discuss the contents of each part.
Answer: The parts of the standard unqualified report are as follows:

- *Report title*. The title must include the word "independent." Examples of appropriate titles are "independent auditor's report," or "report of independent accountant."

- *Report address.* The report is usually addressed to the company's stockholders or board of directors. It should not be addressed to company management.

- *Introductory paragraph*. This paragraph states that an audit was performed to distinguish the report from a compilation or review report. It also lists the financial statements that were audited, including the notes to the financial statements as well as the balance sheet dates and the accounting periods for the income statement and statement of cash flows. The wording of the financial statements in the report should be identical to those used by management on the financial statements.

- *Management's Responsibility section*. This section states that the statements are the responsibility of management. This responsibility includes selecting the appropriate accounting principles and maintaining internal control over financial reporting sufficient for preparation of financial statements that are free of material misstatements due to fraud or error.

- *Auditor's Responsibility section*. This section contains three paragraphs:

The *first* paragraph states that (1) the audit was conducted in accordance with auditing standards generally accepted in the United States of America, (2) the audit is designed to obtain reasonable assurance about whether the statements are free of material misstatement.

The *second* paragraph is called the scope paragraph and describes the scope of the audit and the evidence accumulated. This paragraph indicates that the procedures depend on the auditor's judgment and includes an assessment of the risk of material misstatements in the financial statements. It also indicates that the auditor considers internal control relevant to the preparation and fair presentation of the financial statements in designing the audit procedures performed, but this assessment of internal control is not for the purpose and is not sufficient to express an opinion on the effectiveness of the entity's internal control. The last sentence of the paragraph indicates that the audit includes evaluating the accounting policies selected, the reasonableness of accounting estimates, and the overall financial statement presentation.

The *third* paragraph indicates the auditor believes that sufficient appropriate evidence has been obtained to support the auditor's opinion.

- *Opinion paragraph*. This paragraph states the auditor's conclusions based on the results of the audit. It states that in the auditor's opinion the financial statements present fairly, in all material respects, the financial position of the company as of a certain date, and the results of their operations and cash flows for the the year(s) then ended, in accordance with accounting principles generally accepted in the United States of America.

- *Name of CPA firm*. Typically, the name of the CPA firm, and not the name of an individual auditor, is used.

- *Audit report date*. The audit report is normally dated as of the last day of fieldwork.

Terms: Standard unqualified audit report for a non-public entity; eight parts of the report
Diff: Challenging
Objective: LO 3-1
AACSB: Reflective thinking skills

18) EPM, Inc., is a private manufacturing company with a calendar year-end. Their financial statements include a balance sheet, a statement of income, statement of cash flows, and statement of stockholders' equity. For the most recent audit, Harrington and Perry, LLP, audited the 2011 and 2012 financial statements. The auditors completed all significant fieldwork on March 5, 2013 and issued the audit report on March 16, 2013.

Required:

Consider all the facts given and write the standard unqualified auditor's report, including all eight sections of the report.
Answer: **Independent Auditor's Report**

To the Board of Directors and Shareholders of EPM, Inc.

We have audited the accompanying balance sheets of EPM, Inc., as of December 31, 2012 and 2011, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of EPM, Inc., as of December 31, 2012 and 2011, and the results of their operations and cash flows for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

Harrington and Perry, LLP

March 5, 2013

Terms: Audit report format for private company
Diff: Challenging
Objective: LO 3-1
AACSB: Analytic skills

19) An audit provides a high level of assurance, but is not a guarantee that a material misstatement will exist in the financial statements.
A) True
B) False
Answer: A
Terms: Audit and reasonable assurance
Diff: Moderate
Objective: LO 3-1
AACSB: Reflective thinking skills

20) AICPA auditing standards provide uniform wording for the auditor's report to enable users of the financial statements to understand the audit report.
A) True
B) False
Answer: A
Terms: Uniform wording for auditor's report
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

21) Users of the financial statements rely on the auditor's report because of the absolute assurance the report provides.
A) True
B) False
Answer: B
Terms: Users of financial statements rely on auditor's report
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

22) The introductory paragraph of the auditor's report states that the auditor is responsible for the preparation, presentation and opinion on financial statements.
A) True
B) False
Answer: B
Terms: Introductory paragraph of auditor's report
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

23) The audit report date is the date the auditor completed audit procedures in the field.
A) True
B) False
Answer: A
Terms: Audit report date
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

24) The scope paragraph of the auditor's responsibility section of the audit report issued for financial statements of a non-public company should refer to generally accepted auditing standards .
A) True
B) False
Answer: A
Terms: Audit reports issued for financial statements of private company; Scope paragraph; Generally accepted auditing standards
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills
Topic: Public

25) In the scope paragraph of the audit report issued for financial statements of a non-public company, the auditor expresses an opinion about the internal controls of the company.
A) True
B) False
Answer: B
Terms: Audit reports issued for financial statements of private company; Scope paragraph; Generally accepted auditing standards
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

26) The audit report is normally addressed to the company's president or chief executive officer.
A) True
B) False
Answer: B
Terms: Audit report normally addressed
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

27) The phrase "generally accepted accounting principles" can be found in the opinion paragraph of a standard unqualified report.
A) True
B) False
Answer: A
Terms: Generally accepted accounting principles; Opinion paragraph of standard unqualified report
Diff: Easy
Objective: LO 3-1
AACSB: Reflective thinking skills

28) The date of the auditor's report is indicative of the last day of the auditor's responsibility for the review of significant events occurring after the balance sheet date.
A) True
B) False
Answer: A
Terms: Date of auditor's report indicates auditor's responsibility
Diff: Moderate
Objective: LO 3-1
AACSB: Reflective thinking skills

29) The phrase "auditing standards generally accepted in the United States of America" can be found in the opinion paragraph of a standard, unqualified audit report for a non-public company.
A) True
B) False
Answer: B
Terms: Auditing standards generally accepted in the United States; Opinion paragraph in standard unqualified report for public company
Diff: Moderate
Objective: LO 3-1
AACSB: Reflective thinking skills
Topic: Public

30) The phrase "Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material error" is included in the auditor's opinion section of an audit report.
A) True
B) False
Answer: B
Terms: Standard unqualified audit report for a non-public entity;eight parts of the report
Diff: Moderate
Objective: LO 3-1
AACSB: Reflective thinking skills

Learning Objective 3-2

1) In which of the following situations would the auditor most likely issue an unqualified report?
A) The client valued ending inventory by using the replacement cost method.
B) The client valued ending inventory by using the Next-In-First-Out (NIFO) method.
C) The client valued ending inventory at selling price rather than historical cost.
D) The client valued ending inventory by using the First-In-First-Out (FIFO) method, but showed the replacement cost of inventory in the Notes to the Financial Statements.
Answer: D
Terms: Issued audit report; further audit tests or inquiries
Diff: Challenging
Objective: LO 3-2
AACSB: Reflective thinking skills

2) The standard unqualified audit report:
A) is sometimes called a clean opinion.
B) can be issued only with an explanatory paragraph.
C) can be issued if only a balance sheet and income statement are included in the financial statements.
D) is sometimes called a disclaimer report.
Answer: A
Terms: Conditions for standard unqualified audit report
Diff: Easy
Objective: LO 3-2
AACSB: Reflective thinking skills

3) There are four conditions that must be met before an auditor can issue a standard unqualified report for the audit of a private company. Please discuss each of these five conditions.
Answer: The four conditions that justify issuing a standard unqualified report are:
• All statements–balance sheet, income statement, statement of changes in stockholder's equity, and statement of cash flows–are included in the financial statements.
• Sufficient appropriate evidence has been accumulated, and the auditor has conducted the engagement in a manner that enables him or her to conclude that the audit was performed in accordance with auditing standards.
• The financial statements are presented in accordance with U.S. generally accepted accounting principles or other appropriate accounting framework. This also means that adequate disclosures have been included in the footnotes and other parts of the financial statements.
• There are no circumstances requiring the addition of an explanatory paragraph or modification of the wording of the report.
Terms: Conditions for standard unqualified report for audit of private company
Diff: Moderate
Objective: LO 3-2
AACSB: Reflective thinking skills

Learning Objective 3-3

1) Whenever an auditor issues an audit report for a public company, the auditor can choose to issue a report in which of the following forms?
I. A combined report on financial statements and internal control over financial reporting
II. Separate reports on financial statements and internal control over financial reporting
A) I only
B) II only
C) Either I or II.
D) Neither I nor II.
Answer: C
Terms: Combined report on financial statements and internal control over financial reporting
Diff: Easy
Objective: LO 3-3
AACSB: Reflective thinking skills
Topic: Public

2) The standard unqualified audit report for public entities includes the following three paragraphs:
A) introductory, scope and management's responsibility.
B) materiality, scope and report.
C) introductory, scope and opinion.
D) scope, fieldwork and conclusion.
Answer: C
Terms: Standard unqualified audit report for public entities
Diff: Easy
Objective: LO 3-3
AACSB: Reflective thinking skills
Topic: Public

3) Auditing standards for public companies are established by the:
A) SEC.
B) FASB.
C) PCAOB.
D) IRS.
Answer: C
Terms: Audit standards for public companies; PCAOB
Diff: Easy
Objective: LO 3-3
AACSB: Reflective thinking skills
Topic: Public

4) Section 404(b) of the Sarbanes Oxley Act requires that the auditor of a public company attest to management's report on the efficiency of internal controls over financial reporting.
A) True
B) False
Answer: B
Terms: Section 404(b) of Sarbanes-Oxley Act; Internal controls over financial reporting
Diff: Moderate
Objective: LO 3-3
AACSB: Reflective thinking skills
Topic: Public

5) Auditors of public company financial statements must issue separate reports on internal control over financial reporting.
A) True
B) False
Answer: B
Terms: Auditors issue separate reports on internal control
Diff: Moderate
Objective: LO 3-3
AACSB: Reflective thinking skills
Topic: Public

Learning Objective 3-4

1) Examples of unqualified opinions which contain modified wording (without adding an explanatory paragraph) include:
A) the use of other auditors.
B) material uncertainties.
C) substantial doubt about the audited company (or the entity) continuing as a going concern.
D) lack of consistent application of GAAP.
Answer: A
Terms: Modified unqualified opinion
Diff: Easy
Objective: LO 3-4
AACSB: Reflective thinking skills

2) A CPA may wish to emphasize specific matters regarding the financial statements even though an unqualified opinion will be issued. Normally, such explanatory information is:
A) included in the scope paragraph.
B) included in the opinion paragraph.
C) included in a separate paragraph in the report.
D) included in the introductory paragraph.
Answer: C
Terms: Unqualified opinion with emphasis on specific matters regarding the financial statements
Diff: Easy
Objective: LO 3-4
AACSB: Reflective thinking skills

3) All of the following are causes for the addition of an explanatory paragraph under both AICPA and PCAOB standards **except** for:
A) emphasis of a matter.
B) reports involving other auditors.
C) lack of consistent application of generally accepted accounting principles.
D) auditor agrees with a departure from promulgated accounting principles..
Answer: B
Terms: Unqualified opinion with modified wording
Diff: Easy
Objective: LO 3-4
AACSB: Reflective thinking skills

4) The term "explanatory paragraph" was replaced in the AICPA auditing standards with:
A) going concern paragraph.
B) emphasis-of-matter paragraph.
C) departure from principles paragraph.
D) consistency paragraph.
Answer: B
Terms: Unqualified opinion with modified wording
Diff: Easy
Objective: LO 3-4
AACSB: Reflective thinking skills

5) Which of the following are changes that affect the comparability of financial statements but not the consistency and therefore, do not have to be included in the auditor's report?
A) Error corrections not involving principles
B) Changes in accounting estimates
C) Variations in the format and presentation of financial information
D) All of the above
Answer: D
Terms: Changes that affect the comparability of financial statements
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

6) Which of the following is least likely to cause uncertainty about the ability of an entity to continue as a going concern?
A) The entity is suing a competitor for a minor patent infringement.
B) The entity has lost a major customer.
C) The entity has significant recurring operating losses.
D) The entity has working capital deficiencies.
Answer: A
Terms: Going concern
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

7) When there is uncertainty about a company's ability to continue as a going concern, the auditor's concern is the possibility that the client may not be able to continue its operations or meet its obligations for a "reasonable period of time." For this purpose, a reasonable period of time is considered not to exceed:
A) six months from the date of the financial statements.
B) one year from the date of the financial statements.
C) six months from the date of the audit report.
D) one year from the date of the audit report.
Answer: B
Terms: Going concern ; time period
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

8) When the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, the appropriate audit report could be:
I. an unqualified opinion with an explanatory paragraph.
II. a disclaimer of opinion.
A) I only
B) II only
C) I or II
D) Neither I nor II
Answer: C
Terms: Auditor concludes substantial doubt about entity's ability to continue as going concern
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

9) When a company's financial statements contain a departure from GAAP with which the auditor concurs, the departure should be explained in:
A) the scope paragraph.
B) an explanatory paragraph that appears before the opinion paragraph.
C) the opinion paragraph.
D) an explanatory paragraph after the opinion paragraph.
Answer: D
Terms: Justified Departure
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

10) William Gregory, CPA, is the principal auditor for a multi-national corporation. Another CPA has examined and reported on the financial statements of a significant subsidiary of the corporation. Gregory is satisfied with the independence and professional reputation of the other auditor, as well as the quality of the other auditor's examination. With respect to his report on the consolidated financial statements, taken as a whole, Gregory:
A) must not refer to the examination of the other auditor.
B) must refer to the examination of the other auditor.
C) may refer to the examination of the other auditor.
D) must refer to the examination of the other auditors along with the percentage off consolidated assets and revenue that they audited.
Answer: C
Terms: Reports involving other auditors
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

11) A company has changed its method of inventory valuation from an unacceptable one to one in conformity with generally accepted accounting principles. The auditor's report on the financial statements of the year of the change should include:
A) no reference to consistency.
B) a reference to a prior period adjustment in the opinion paragraph.
C) an explanatory paragraph that justifies the change and explains the impact of the change on reported net income.
D) an explanatory paragraph explaining the change.
Answer: D
Terms: Consistency modifications
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

12) Which of the following modifications of the auditor's report does **not** include an explanatory paragraph?
A) A qualified report is due to a GAAP departure.
B) The report includes an emphasis of a matter.
C) There is a very material scope limitation.
D) A principal auditor accepts the work of an other auditor.
Answer: D
Terms: Shared opinions
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

13) No reference is made in the auditor's report to other auditors who perform a portion of the audit when:
I. The other auditor audited an immaterial portion of the audit.
II. The other auditor is well known or closely supervised by the principle auditor.
III. The principle auditor has thoroughly reviewed the work of the other auditor.
A) I and II
B) I and III
C) II and III
D) I, II and III
Answer: D
Terms: Shared opinions
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

14) When an auditor is trying to determine how changes can affect consistency and and/or comparability, he should keep in mind that:
A) changes that affect comparability but not consistency require an explanatory paragraph.
B) items that materially affect the comparability of financial statements requires a disclaimer of opinion.
C) changes that affect consistency require an explanatory paragraph if they are material.
D) changes that involve either comparability or consistency only need to be mentioned in the footnotes.
Answer: C
Terms: Standard audit report; explanatory paragraph; consistency and comparability
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

15) All of the following would require an emphasis of matter paragraph **except** for:
A) the existence of material related party transactions.
B) the lack of auditor independence.
C) important events occurring subsequent to the balance sheet date.
D) material uncertainties disclosed in the footnotes.
Answer: B
Terms: Unqualified opinion with emphasis on specific matters regarding the financial statements
Diff: Easy
Objective: LO 3-4
AACSB: Analytic skills

16) Under AICPA auditing standards, the primary auditor issuing the opinion on the financial statements is called the:
A) component auditor.
B) principal auditor.
C) group engagement partner.
D) majority auditor.
Answer: C
Terms: Reports involving other auditors
Diff: Easy
Objective: LO 3-4
AACSB: Reflective thinking skills

17) Which of the following is false concerning the principal CPA firm's alternatives when issuing a report when another CPA firm performs part of the audit?
A) Issue a joint report signed by both CPA firms.
B) Make no reference to the other CPA firm in the audit report, and issue the standard unqualified opinion.
C) Make reference to the other auditor in the report by using modified wording (a shared opinion or report).
D) A qualified opinion or disclaimer, depending on materiality, is required if the principal auditor is not willing to assume any responsibility for the work of the other auditor.
Answer: A
Terms: Shared opinions
Diff: Challenging
Objective: LO 3-4
AACSB: Reflective thinking skills

18) Which of the following requires recognition in the auditor's opinion as to consistency?
A) The correction of an error in the prior year's financial statements resulting from a mathematical mistake in capitalizing interest.
B) A change in the estimate of provisions for warranty costs.
C) The change from the cost method to the equity method of accounting for investments in common stock.
D) A change in depreciation method which has no effect on current year's financial statements but is certain to affect future years.
Answer: C
Terms: Consistency
Diff: Challenging
Objective: LO 3-4
AACSB: Reflective thinking skills

19) Indicate which changes would require an explanatory paragraph in the audit report.

A)

Correction of an error by changing from an accounting principle that is not generally acceptable to one that is generally acceptable	Change from LIFO to FIFO
Yes	Yes

B)

Correction of an error by changing from an accounting principle that is not generally acceptable to one that is generally acceptable	Change from LIFO to FIFO
No	No

C)

Correction of an error by changing from an accounting principle that is not generally acceptable to one that is generally acceptable	Change from LIFO to FIFO
Yes	No

D)

Correction of an error by changing from an accounting principle that is not generally acceptable to one that is generally acceptable	Change from LIFO to FIFO
No	Yes

Answer: A
Terms: Changes that require explanatory paragraph in audit report
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

20) Indicate which changes would require an explanatory paragraph in the audit report.

A)

Change in the estimated life of an asset	Variation in the format of the financial statements
Yes	Yes

B)

Change in the estimated life of an asset	Variation in the format of the financial statements
No	No

C)

Change in the estimated life of an asset	Variation in the format of the financial statements
Yes	No

D)

Change in the estimated life of an asset	Variation in the format of the financial statements
No	Yes

Answer: B
Terms: Changes that require explanatory paragraph in audit report
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

21) Indicate which changes would require an explanatory paragraph in the audit report.

A)

The CPA concludes there is substantial doubt about the entity's ability to continue as a going concern	Change from FIFO to LIFO
Yes	Yes

B)

The CPA concludes there is substantial doubt about the entity's ability to continue as a going concern	Change from FIFO to LIFO
No	No

C)

The CPA concludes there is substantial doubt about the entity's ability to continue as a going concern	Change from FIFO to LIFO
Yes	No

D)

The CPA concludes there is substantial doubt about the entity's ability to continue as a going concern	Change from FIFO to LIFO
No	Yes

Answer: A
Terms: Changes that would require an explanatory paragraph in audit report
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

22) Indicate which changes would require an explanatory paragraph in the audit report.

A)

A departure from GAAP which, due to unusual circumstances, does not require a qualified or adverse opinion.	The CPA makes reference to the work of another auditor to indicate shared responsibility in an unqualified opinion.
Yes	Yes

B)

A departure from GAAP which, due to unusual circumstances, does not require a qualified or adverse opinion.	The CPA makes reference to the work of another auditor to indicate shared responsibility in an unqualified opinion.
No	No

C)

A departure from GAAP which, due to unusual circumstances, does not require a qualified or adverse opinion.	The CPA makes reference to the work of another auditor to indicate shared responsibility in an unqualified opinion.
Yes	No

D)

A departure from GAAP which, due to unusual circumstances, does not require a qualified or adverse opinion.	The CPA makes reference to the work of another auditor to indicate shared responsibility in an unqualified opinion.
No	Yes

Answer: C
Terms: Changes that would require an explanatory paragraph in audit report
Diff: Challenging
Objective: LO 3-4
AACSB: Reflective thinking skills

23) Discuss each of the five circumstances when an auditor would issue an unqualified audit report with an explanatory paragraph or modified wording.
Answer: An unqualified report with an explanatory paragraph or modified wording is appropriate in the following circumstances:
• *Lack of consistent application of GAAP*. When the client has not followed generally accepted accounting principles consistently in the current period in relation to the preceding period, an unqualified opinion with an explanatory paragraph following the opinion paragraph is appropriate.
• *Substantial doubt about continuing as a going concern*. When an auditor concludes there is substantial doubt about the client's ability to continue as a going concern, an unqualified opinion with an explanatory paragraph following the opinion paragraph is appropriate. The auditor also has the option of issuing a disclaimer of opinion.
• *A departure from GAAP with which the auditor concurs*. If adherence to GAAP would result in misleading financial statements, an unqualified opinion with an explanatory paragraph is appropriate.
• *Emphasis of a matter*. If the auditor wants to emphasize specific matters in the audit report, an explanatory paragraph discussing those matters may be added to an unqualified report.
• *Reports involving other auditors*. When an auditor relies upon a different CPA firm to perform part of the audit, the auditor can indicate that responsibility for the audit is shared with another CPA firm by modifying the wording of an unqualified report.
Terms: Circumstances where an auditor will issue modified unqualified report with explanatory paragraph or modified wording
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

24) A modified unqualified audit report arises when the auditor believes the financials are fairly stated but also believes additional information should be provided.
A) True
B) False
Answer: A
Terms: Modified unqualified audit report
Diff: Easy
Objective: LO 3-4
AACSB: Reflective thinking skills

25) Changes in accounting estimates requires the auditor to issue a modified unqualified audit report with a consistency paragraph inserted after the opinion paragraph.
A) True
B) False
Answer: B
Terms: Changes of accounting estimates; Modified unqualified audit report
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

26) The only modified unqualified opinion that does not include an explanatory paragraph is when other auditors are involved. In this case only the introductory paragraph is modified.
A) True
B) False
Answer: B
Terms: Modified unqualified opinion
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

27) Items that materially affect the comparability of the financial statements generally require disclosure in the footnotes.
A) True
B) False
Answer: A
Terms: Items that materially affect comparability of financial statements
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

28) Changes in an estimate, such as a change in the estimated useful life of an asset for depreciation purposes, affect consistency but not comparability, and therefore require an explanatory paragraph in the audit report.
A) True
B) False
Answer: B
Terms: Comparability vs. consistency
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

29) Changes in reporting entities, such as the inclusion of an additional company in combined financial statements, affect comparability but not consistency, and therefore do **not** require an explanatory paragraph in the audit report.
A) True
B) False
Answer: B
Terms: Comparability and consistency
Diff: Challenging
Objective: LO 3-4
AACSB: Reflective thinking skills

30) When an auditor relies upon a different CPA firm to perform part of the audit and chooses to issue a shared opinion, only the auditor's responsibility paragraph should be modified.
A) True
B) False
Answer: B
Terms: Auditor reliance on different CPA firm to perform part of audit; Shared opinion
Diff: Moderate
Objective: LO 3-4
AACSB: Reflective thinking skills

31) When other auditors are involved in the audit and they qualify their portion of the audit, the principal auditor must decide if the amount in question is material to the financial statements as a whole.
A) True
B) False
Answer: A
Terms: Shared responsibility
Diff: Challenging
Objective: LO 3-4
AACSB: Reflective thinking skills

Learning Objective 3-5

1) As a result of management's refusal to permit the auditor to physically examine inventory, the auditor must depart from the unqualified audit report because:
A) the financial statements have not been prepared in accordance with GAAP.
B) the scope of the audit has been restricted by circumstances beyond either the client's or auditor's control.
C) the financial statements have not been audited in accordance with GAAS.
D) the scope of the audit has been restricted.
Answer: D
Terms: Auditor must depart from unqualified audit report; Management refusal to permit the auditor to physically examine inventory
Diff: Easy
Objective: LO 3-5
AACSB: Reflective thinking skills

2) An adverse opinion is issued when the auditor believes:
A) some parts of the financial statements are materially misstated or misleading.
B) the financial statements would be found to be materially misstated if an investigation were performed.
C) the auditor is not independent.
D) the overall financial statements are so materially misstated that they do not present fairly the financial position or results of operations and cash flows in conformity with GAAP.
Answer: D
Terms: Adverse opinion
Diff: Easy
Objective: LO 3-5
AACSB: Reflective thinking skills

3) An auditor can express a qualified opinion due to a:
A)

Departure from GAAP	Lack of Consistency	Lack of Sufficient Evidence
Yes	No	No

B)

Departure from GAAP	Lack of Consistency	Lack of Sufficient Evidence
No	Yes	No

C)

Departure from GAAP	Lack of Consistency	Lack of Sufficient Evidence
Yes	No	Yes

D)

Departure from GAAP	Lack of Consistency	Lack of Sufficient Evidence
Yes	Yes	Yes

Answer: C
Terms: Qualified opinions
Diff: Easy
Objective: LO 3-5
AACSB: Reflective thinking skills

4) An auditor determines the financial statements include at least a material departure from GAAP. Which type of opinion may be issued?

A)

Disclaimer	Qualified	Adverse
Yes	No	No

B)

Disclaimer	Qualified	Adverse
No	Yes	No

C)

Disclaimer	Qualified	Adverse
Yes	No	Yes

D)

Disclaimer	Qualified	Adverse
No	Yes	Yes

Answer: D
Terms: Opinion , GAAP departure
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

5) A qualified opinion can be issued for which of the following?
I. When a limitation on the scope of the audit has occurred
II. When the auditor lacks independence
III. When generally accepted accounting principles have not been used
A) I and II
B) I and III
C) II and III
D) I, II and III
Answer: B
Terms: Qualified opinion
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

6) In which situation would the auditor be choosing between "except for" qualified opinion and an adverse opinion?
A) The auditor lacks independence.
B) A client-imposed scope limitation
C) A circumstance imposed scope limitation
D) Lack of full disclosure within the footnotes
Answer: D
Terms: Qualified opinion and adverse opinion
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

7) When the auditor determines that the financial statements are fairly stated, but there is a nonindependent relationship between the auditor and the client, the auditor should issue:
A) an adverse opinion.
B) a disclaimer of opinion.
C) either a qualified opinion or an adverse opinion.
D) either a qualified opinion or an unqualified opinion with modified wording.
Answer: B
Terms: Audit report when auditor not independent
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

8) If the auditor lacks independence, a disclaimer of opinion must be issued:
A) if the client requests it.
B) only if it is highly material.
C) only if it is material but not pervasive.
D) in all cases.
Answer: D
Terms: Disclaimer when auditor lacks independence
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

9) If the phrase "except for" is present in the opinion paragraph of the audit report, the auditor has issued a(n):
A) adverse opinion.
B) disclaimer of opinion.
C) unqualified opinion.
D) qualified opinion.
Answer: D
Terms: Departure from unqualified audit report
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

10) A client has changed their method of valuing inventory from FIFO to LIFO and the change has a material effect on the financial statements. If the auditor does not concur with the appropriateness of the change, the auditor should issue a(n):
A) disclaimer.
B) adverse opinion.
C) unqualified opinion.
D) qualified opinion.
Answer: D
Terms: Change in valuing inventory and auditor does not concur with change
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

11) Items that materially affect the comparability of financial statements generally require disclosure in the footnotes. If the client refuses to properly disclose the item, the auditor will most likely issue:
A) a disclaimer.
B) an unqualified opinion.
C) a qualified opinion.
D) an adverse opinion.
Answer: C
Terms: Disclosure and comparability
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

12) Which of the following scenarios does **not** result in a qualified opinion?
A) A scope limitation prevents the auditor from completing an important audit procedure.
B) Circumstances exist that prevent the auditor from conducting a complete audit.
C) The auditor lacks independence with respect to the audited entity.
D) An accounting principle at variance with GAAP is used.
Answer: C
Terms: Qualified opinion
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

13) Whenever the client imposes restrictions on the scope of the audit, the auditor should be concerned that management may be trying to prevent discovery of misstatements. In such cases, the auditor will likely issue a:
A) disclaimer of opinion in all cases.
B) qualification of both scope and opinion in all cases.
C) disclaimer of opinion whenever materiality is in question.
D) qualification of both scope and opinion whenever materiality is in question.
Answer: C
Terms: Client imposed restrictions on scope of audit
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

14) In which of the following circumstances would an auditor most likely express an adverse opinion?
A) The CEO refuses to let the auditor have access to the board of director meeting minutes.
B) The financial statements are not in conformity with the FASB statement on loss contingencies.
C) Information comes to the auditor's attention that raises substantial doubt about the ability for the client to continue as a going concern.
D) Tests of controls show that the internal control structure is so poor that the auditor has to assess control risk at the maximum.
Answer: B
Terms: Adverse opinion circumstances
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

15) Which of the following statements is true?
I. The auditor is required to issue a disclaimer of opinion in the event of a material uncertainty.
II. The auditor is required to issue a disclaimer of opinion in the event of a going concern problem.
A) I only
B) II only
C) I and II
D) Neither I nor II
Answer: D
Terms: Disclaimer of opinion
Diff: Challenging
Objective: LO 3-5
AACSB: Reflective thinking skills

16) The most common case in which conditions beyond the client's and auditor's control cause a scope restriction in an engagement is when the:
A) auditor is not appointed until after the client's year-end.
B) client won't allow the auditor to confirm receivables for fear of offending its customers.
C) auditor doesn't have enough staff to satisfactorily audit all of the client's foreign subsidiaries.
D) client is going through Chapter 11 bankruptcy.
Answer: A
Terms: Scope restriction beyond client and auditor control
Diff: Challenging
Objective: LO 3-5
AACSB: Reflective thinking skills

17) When the client fails to make adequate disclosure in the body of the statements or in the related footnotes, it is the responsibility of the auditor to:
A) inform the reader that disclosure is not adequate, and to issue an adverse opinion.
B) inform the reader that disclosure is not adequate, and to issue a qualified opinion.
C) present the information in the audit report and issue an unqualified or qualified opinion.
D) present the information in the audit report and to issue a qualified or an adverse opinion.
Answer: D
Terms: Inadequate disclosure
Diff: Challenging
Objective: LO 3-5
AACSB: Reflective thinking skills

18) There are three conditions necessitating a departure from an unqualified audit report. Name, discuss and state the appropriate audit report for each of these three conditions.
Answer: The three conditions requiring a departure from an unqualified report are:
• Scope Restrictions. A scope restriction can be imposed by the client or due to circumstances beyond the auditor's or client's control. In either case the scope restriction prevents the auditor from accumulating sufficient evidence to reach a conclusion regarding whether financial statements are stated in accordance with GAAP. The type of opinion, depending upon materiality, would be either a qualified or a disclaimer of opinion report.
• GAAP Departures. In this situation the financial statements are not prepared in accordance with GAAP. Accordingly, the auditor would issue a qualified opinion if the GAAP violation were moderately material, or an adverse opinion if the GAAP violation were highly material.
• Auditor lacks independence. Independence is ordinarily determined by Rule 101 of the rules of the Code of Professional Conduct. When the auditor is not independent, the only report the auditor can issue is a disclaimer of opinion.
Terms: Conditions necessitating a departure from an unqualified audit report
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

19) A qualified audit report is issued when all auditing conditions have been met, no significant misstatements have been discovered, and it is the auditor's opinion that the financial statements are fairly stated in accordance with GAAP.
A) True
B) False
Answer: B
Terms: Qualified report
Diff: Easy
Objective: LO 3-5
AACSB: Reflective thinking skills

20) Auditors should issue a disclaimer of opinion when there is a highly material client-imposed scope restriction.
A) True
B) False
Answer: A
Terms: Disclaimer of opinion; Client-imposed scope restriction
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

21) Whenever an auditor issues a qualified report, he or she must use the term "except for " in the opinion paragraph.
A) True
B) False
Answer: A
Terms: Qualified report; Except for in opinion paragraph
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

22) A qualified report can take the form of a qualification of both the scope and the opinion or of the opinion alone.
A) True
B) False
Answer: A
Terms: Qualified report; Scope limitation
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

23) When an auditor discovers a highly material GAAP violation in the financial statements and the client refuses to correct it, the auditor should issue a disclaimer of opinion.
A) True
B) False
Answer: B
Terms: Disclaimer of opinion; Highly material GAAP violation in the financial statements and client refuses to correct it
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

24) Client imposed restrictions on the audit always require a disclaimer of opinion.
A) True
B) False
Answer: B
Terms: Disclaimer of opinion; Client imposed restrictions on audit
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

25) An auditor should issue a qualified opinion with an explanatory paragraph whenever there is a material uncertainty affecting the financial statements.
A) True
B) False
Answer: B
Terms: Qualified opinion with explanatory paragraph
Diff: Moderate
Objective: LO 3-5
AACSB: Reflective thinking skills

Learning Objective 3-6

1) A misstatement in the financial statements can be considered material if knowledge of the misstatement will affect a decision of:
A) the PCAOB.
B) a reasonable user of the financial statements.
C) an accountant.
D) the SEC.
Answer: B
Terms: Materiality
Diff: Moderate
Objective: LO 3-6
AACSB: Reflective thinking skills

2) Misstatements must be compared with some measurement base before a decision can be made about materiality. A commonly accepted measurement base includes:
A) net income.
B) total assets.
C) working capital.
D) all of the above.
Answer: D
Terms: Misstatements and materiality
Diff: Moderate
Objective: LO 3-6
AACSB: Reflective thinking skills

3) When comparing misstatements with a measurement base, the auditor must consider the pervasiveness of the misstatement. Of the following examples, the most pervasive misstatement is a(n):
A) understatement of inventory.
B) understatement of retained earnings caused by a miscalculation of dividends payable.
C) misclassification of notes payable as a long-term liability when it should be current.
D) misclassification of salary expense as a selling expense.
Answer: A
Terms: Pervasive misstatements
Diff: Moderate
Objective: LO 3-6
AACSB: Reflective thinking skills

4) The dollar amount of some misstatements cannot be accurately measured. For example, if the client were unwilling to disclose an existing lawsuit, the auditor must estimate the likely effect on:
A) net income.
B) users of the financial statements.
C) the auditor's exposure to lawsuits.
D) management's future decisions.
Answer: B
Terms: Misstatements accurately measured
Diff: Moderate
Objective: LO 3-6
AACSB: Reflective thinking skills

5) If most or all users' decisions that are based on the financial statements are likely to be significantly affected, the materiality level is:
A) unrestricted.
B) material.
C) pervasive.
D) risky.
Answer: C
Terms: Materiality qualifications
Diff: Moderate
Objective: LO 3-6
AACSB: Reflective thinking skills

6) When a client fails to follow GAAP, the audit report can be unqualified, qualified, or adverse depending on the materiality. What factors affect materiality that an auditor should consider?
A) The dollar amount in comparison to a base
B) If the misstatement can be measured
C) The nature of the item
D) All the above are factors an auditor should consider regarding materiality.
Answer: D
Terms: Client fails to follow GAAP; Materiality
Diff: Moderate
Objective: LO 3-6
AACSB: Reflective thinking skills

7) Which of the following is a correct statement regarding materiality?
A) There are well-defined guidelines that enable auditors to determine if something is material.
B) Misstatements must be compared with some benchmark before a decision can be made about the materiality level of the failure of a company to follow GAAP.
C) Pervasiveness is not considered when comparing potential misstatements with a base or benchmark.
D) To evaluate overall materiality, the auditor does not combine all unadjusted misstatements.
Answer: B
Terms: Materiality
Diff: Moderate
Objective: LO 3-6
AACSB: Reflective thinking skills

8) Discuss how materiality affects audit reporting decisions.
Answer: When determining the appropriate audit report to issue, the auditor considers three levels of materiality for a given condition. These three levels are (1) immaterial, (2) material without overshadowing the financial statements as a whole, and (3) so material and so pervasive that overall fairness of the statements is in question. For conditions involving a GAAP violation, the materiality level of the violation influences whether an unqualified, qualified, or adverse opinion is issued. For conditions involving a scope restriction, the materiality of the restriction influences whether an unqualified report, a qualified scope and opinion report, or a disclaimer of opinion is issued.
Terms: Materiality affect on audit reporting decisions
Diff: Easy
Objective: LO 3-6
AACSB: Reflective thinking skills

9) Materiality is essential when an auditor considers his/her determination of the appropriate report for a given set of circumstances.
A) True
B) False
Answer: A
Terms: Materiality; Appropriate report
Diff: Easy
Objective: LO 3-6
AACSB: Reflective thinking skills

10) A pervasive exception is one that affects different parts of the financial statements.
A) True
B) False
Answer: A
Terms: Pervasive exception
Diff: Easy
Objective: LO 3-6
AACSB: Reflective thinking skills

11) An item with a "psychic" effect (e.g., where the item maintains an increasing earnings trend) is a qualitative factor that may affect the auditors decision regarding materiality.
A) True
B) False
Answer: A
Terms: Psychic effect; Materiality
Diff: Challenging
Objective: LO 3-6
AACSB: Reflective thinking skills

Learning Objective 3-7

1) The explanatory paragraph for a qualified opinion would:
A) precede the scope paragraph.
B) follow the scope paragraph.
C) follow the opinion paragraph.
D) either precede or follow the opinion paragraph depending on the materiality.
Answer: B
Terms: Explanatory paragraph for qualified opinion
Diff: Easy
Objective: LO 3-7
AACSB: Reflective thinking skills

2) An auditor who issues a qualified opinion because sufficient appropriate evidence was not obtained should describe the limitations in an explanatory paragraph. The auditor should also modify the:
A)

Scope paragraph	Opinion paragraph	Notes to the financial statements
Yes	No	Yes

B)

Scope paragraph	Opinion paragraph	Notes to the financial statements
No	Yes	Yes

C)

Scope paragraph	Opinion paragraph	Notes to the financial statements
No	Yes	No

D)

Scope paragraph	Opinion paragraph	Notes to the financial statements
Yes	Yes	No

Answer: D
Terms: Qualified opinion insufficient evidence
Diff: Challenging
Objective: LO 3-7
AACSB: Reflective thinking skills

3) When an auditor issues a qualified report due to a scope limitation an explanatory paragraph is normally added. Which, if any, of the following paragraphs are also modified?
A)

Introductory	Scope	Opinion
Yes	Yes	Yes

B)

Introductory	Scope	Opinion
Yes	Yes	No

C)

Introductory	Scope	Opinion
No	Yes	No

D)

Introductory	Scope	Opinion
No	Yes	Yes

Answer: D
Terms: Qualified report due to scope restriction; Paragraphs modified
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

4) When a qualified or adverse opinion is issued, the qualifying paragraph is inserted:
A) between the introductory and scope paragraphs.
B) between the scope and opinion paragraphs.
C) after the opinion paragraph, as a fourth paragraph.
D) immediately after the address, as the first paragraph.
Answer: B
Terms: Qualified or adverse opinion paragraph placement
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

5) The independent auditor must issue a qualified opinion when which of the financial(s) are missing?
I. Balance Sheet
II. Income Statement
III. Statement of Cash Flows
A) I only
B) II only
C) III only
D) I, II, and III
Answer: C
Terms: Qualified opinion issued when which financial statement is missing
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

6) If the financial statements include an income statement and a balance sheet but exclude the statement of cash flows, the auditors:
A) can issue an unqualified report.
B) should issue a qualified opinion due to the departure from GAAP.
C) should issue a qualified opinion because the missing statement of cash flows constitutes a scope limitation.
D) should include the statement of cash flows, modify the report and issue an unqualified opinion.
Answer: B
Terms: Report when financial statements exclude statement of cash flows
Diff: Challenging
Objective: LO 3-7
AACSB: Reflective thinking skills

7) Which of the following is incorrect concerning scope limitations?
A) If client imposed, the auditor should be concerned about the client trying to prevent discovery of a material misstatement.
B) An unqualified opinion can result if auditors can perform alternative procedures and are satisfied that the information is fairly stated.
C) The most common circumstance imposed scope restriction is due to the client changing their auditors.
D) The most common circumstance imposed scope limitation is when the auditor is appointed after the balance sheet date.
Answer: C
Terms: Scope limitation
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

8) When dealing with materiality and scope limitation conditions:
A) a disclaimer of opinion must be issued.
B) it is easier to evaluate the materiality of potential misstatements resulting from a scope limitation than for failure to follow GAAP.
C) scope limitations imposed by the client are always considered material.
D) a unqualified opinion may still be issued depending on the materiality of the scope limitation.
Answer: D
Terms: Scope limitation
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

9) When a pervasive scope limitation exists:
A) a disclaimer of opinion rather than a qualified opinion is generally required.
B) the auditor's responsibility paragraph is modified to indicate that the auditor was not able to obtain sufficient appropriate evidence to express an audit opinion.
C) sections of the auditor's responsibility paragraph are eliminated to avoid stating anything that might lead readers to believe that other parts of the financial statements might be fairly stated.
D) all of the above.
Answer: D
Terms: Pervasive scope limitation
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

10) When there is a scope restriction, what type of audit report can be issued?
A) Unqualified opinion
B) Qualification of scope and opinion
C) Disclaimer of opinion
D) Any of the above
Answer: D
Terms: Audit reports in various situations
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

11) Subsequent to the close of Spacely Sprockets fiscal year ending October 31, 2012, a major debtor has declared bankruptcy due to a series of events. The receivable is significantly material in relation to the financial statements, and recovery is doubtful. The debtor had confirmed the full amount due to Spacely Sprocket at the balance sheet date. Because the account was confirmed at the balance sheet date, Spacely refuses to disclose any information in relation to this subsequent event. The CPA believes that all other accounts were stated fairly at the balance sheet date. In addition, Spacely changed their method of inventory valuation from FIFO to LIFO. This change was disclosed in Note X to the financial statements. Accordingly, what type of opinion should be expressed?
A) Unqualified with an explanatory paragraph.
B) Qualified due to a GAAP departure.
C) Qualified due to a scope limitation.
D) A combination of B and C.
Answer: B
Terms: Audit report when client has subsequent event and change in inventory valuation
Diff: Challenging
Objective: LO 3-7
AACSB: Reflective thinking skills

12) For the report containing a disclaimer for lack of independence, the disclaimer is in the:
A) second or scope paragraph.
B) third or opinion paragraph.
C) first and only paragraph.
D) fourth or explanatory paragraph.
Answer: C
Terms: Disclaimer in which report paragraph
Diff: Challenging
Objective: LO 3-7
AACSB: Reflective thinking skills

13) When an adverse opinion is issued, a scope paragraph would be:
A) qualified.
B) unchanged.
C) deleted.
D) expanded to identify the additional procedures which the auditor performed.
Answer: B
Terms: Adverse opinion and scope paragraph
Diff: Challenging
Objective: LO 3-7
AACSB: Reflective thinking skills

14) After the balance sheet date but prior to issuance of the auditor's report the auditor learns that the client's facility in a foreign country has been expropriated. Management refuses to disclose this information in a financial statement footnote or present pro-forma data as to the effect of the event. The auditor should:
A) add a footnote to the financial statements.
B) disclaim an opinion due to the client imposed scope limitation.
C) provide the information in the report and modify the opinion.
D) issue an unqualified opinion but provide the information in the auditor report.
Answer: C
Terms: Material subsequent event management refusal to disclose
Diff: Challenging
Objective: LO 3-1 and LO 3-7
AACSB: Reflective thinking skills

15) The following is a portion of an adverse audit report issued for a public company. (Note: A separate report was issued on the effectiveness of internal control over financial reporting.)

Independent Auditor's Report

To the shareholders of Wallace Corporation

We have audited the accompanying balance sheet of Wallace Corporation as of December 31, 2012, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The company has excluded from property and debt in the accompanying balance sheet certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by $14,500,000, long-term debt by $13,200,000, and retained earnings by $1,300,000 as of December 31, 2012, and net income and earnings per share would be increased by $1,300,000 and $2.25, respectively, for the year then ended.

Required:

Complete the above adverse audit report by preparing the opinion paragraph. Do not date or sign the report.

Answer: In our opinion, because of the significance of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly the financial position of Wallace Corporation as of December 31, 2012, or the results of its operations and its cash flows for the year then ended.
Terms: Adverse audit report
Diff: Challenging
Objective: LO 3-7
AACSB: Analytic skills
Topic: Public

16) The following is the introductory paragraph, and the Basis for Qualified Opinion paragraph for Fast Times Corporation, a non-public company.

Independent Auditor's Report

To the shareholders of Fast Times Corporation

We have audited the accompanying balance sheet of Fast Times Corporation as of September 30, 2012, and the related statements of income, retained earnings, and cash flows for the year then ended, and the related notes to the financial statements.

Basis for Qualified Opinion

We were unable to obtain audited financial statements supporting the company's investment in a foreign affiliate stated at $1,040,000, or its equity in earnings of that affiliate of $501,000, which is included in net income, as described in Note 14 to the financial statements. Because of the nature of the company's records, we were unable to satisfy ourselves as to the carrying value of the investment or the equity in its earnings by means of other auditing procedures.

Required:

Prepare the opinion paragraph for the above audit report. Do not date or sign the report.
Answer: In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of Fast Times Corporation as of September 30, 2012, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.
Terms: Qualified scope and opinion report
Diff: Challenging
Objective: LO 3-7
AACSB: Analytic skills
Topic: Public

17) Your CPA firm has completed the fieldwork for the 2012 audit of Sharp Corporation, a private company with an October year-end. You were preparing to draft a standard, unqualified audit report when you discovered that the audit manager on the Sharp engagement owns 10 shares of Sharp's common stock. Prepare the appropriate report.
Answer: We are not independent with respect to Sharp Corporation, and the accompanying balance sheet as of October 31, 2012, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us. Accordingly, we do not express an opinion on them.

Note: There is no report title when the auditor issues a disclaimer due to a lack of independence.
Terms: Audit report with lack of independence
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

18) Assume you are the partner in charge of the 2012 audit of Becker Corporation, a private company. The audit report has not yet been prepared. In each independent situation following (1-8), indicate the appropriate action (a-g) to be taken. The possible actions are as follows:

a. Issue a standard unqualified report.
b. Qualify both the scope and opinion paragraphs.
c. Qualify the opinion paragraph.
d. Issue an unqualified opinion with an explanatory paragraph.
e. Issue an unqualified opinion with modified wording (no explanatory paragraph).
f. Issue an adverse opinion.
g. Disclaim an opinion.

The situations are as follows:
________ 1. Becker Corporation carries its property, plant, and equipment accounts at current market values. Current market values exceed historical cost by a highly material amount, and the effects are pervasive throughout the financial statements.

________ 2. Management of Becker Corporation refuses to allow you to observe, or make, any counts of inventory. The recorded book value of inventory is highly material.

________ 3. You were unable to confirm accounts receivable with Becker's customers. However, because of detailed sales and cash receipts records, you were able to perform reliable alternative audit procedures.

________ 4. One week before the end of fieldwork, you discover that the audit manager on the Becker engagement owns a material amount of Becker's common stock.

________ 5. You relied upon another CPA firm to perform part of the audit. Although you were the principal auditor, the other firm audited a material portion of the financial statements. You wish to refer to (but not name) the other firm in your report.

________ 6. You have substantial doubt about Becker's ability to continue as a going concern.

________ 7. Becker Corporation changed its method of computing depreciation in 2012. You concur with the change and the change is properly disclosed in the financial statement footnotes.

________ 8. Ten days after the balance sheet date, one of Becker's buildings was destroyed by a fire. Becker refuses to disclose this information in a footnote to the financial statements, but you believe disclosure is required to conform with GAAP. The amount of the uninsured loss was material, but not highly material.

Answer:
1. f
2. g
3. a
4. g
5. e
6. d or g
7. d
8. c
Terms: Audit reports in various situations
Diff: Challenging
Objective: LO 3-1, LO 2-4, LO 3-5, and LO 3-7
AACSB: Analytic skills

19) Smith and Jones, CPAs, audited the consolidated financial statements of Concord Inc. and all but one of its subsidiaries for the year ended September 30, 2012 and are expressing an unqualified opinion on the financials presented as a whole.

Smith, the engagement partner, instructed Mary, an assistant on the engagement, to draft the auditor's report on November 4, 2012, the date of fieldwork completion. In drafting the report Mary considered the following:

• In preparing its financial statements, Concord changed its method of accounting for research and development costs and properly expensed these amounts. Management described the change in principle in Note 10 to the consolidated financial statements.
• Ball & Brown, CPAs, audited the financial statements of Biotherm, Inc., a consolidated subsidiary of Concord for the year ended September 30, 2012. The subsidiary's financial statements reflect total assets of 22% and total revenues of 20% of the consolidated totals. Ball & Brown expressed an unqualified opinion and furnished to Smith & Jones a copy of their auditor report. Smith & Jones have decided not to assume responsibility for the work of Ball & Brown insofar as it relates to the expression of an opinion on the consolidated financial statements taken as a whole because of the materiality of Biotherm's financial statements to the consolidated whole. Ball & Brown's report will not be presented together with that of Smith & Jones.
• Concord is the subject of a grand jury investigation into possible violations of federal antitrust laws and possible related crimes. Related civil class actions are pending. Concord's management has adequately disclosed in Note 12 to their consolidated financial statements. Because of the early stage of the investigation, the ultimate outcome of these matters cannot be determined at this time. Therefore, no provision for any liability that may result has been recorded.
• Concord experienced a net loss in 2012 and is currently in default under substantially all of its debt agreements. Management's plans in regard to these matters are adequately disclosed in Note 14 to Concord's consolidated financial statements. The financials do not include any adjustments that might result from the outcome of this uncertainty. These matters rase substantial doubt about Concord's ability to continue as a going concern.

Ball reviewed Mary's draft and indicated in his review notes that there were many deficiencies in Mary's Draft. The audit report that Mary drafted follows.

Independent Auditor's Report

We have audited the consolidated financial statements of Concord, Inc., and subsidiaries as of September 30, 2012, and the related consolidated statements of income, changes in stockholders equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Biotherm, Inc., a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 22% and 20% respectively at September 30, 2012 of the consolidated totals. Those statements were audited by Ball & Brown, CPAs, whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for Biotherm, Inc. is based solely on their report.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used, as well as assessing control risk. We believe our audits provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Concord Inc., as of September 30, 2012 in conformity with generally accepted accounting principles, except for the uncertainty, which is discussed in Note 12 to the consolidated financials.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue in existence for a reasonable period of time. As discussed in Note 14 to the consolidated financial statements, the Company suffered a net loss and is currently in default under substantially all of its debt agreements. Management's plans in regard to these matters are also described in Note 14. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Smith & Jones, CPAs
November 4, 2012

Required:
The following items present some of the deficiencies in the drafted audit report noted by Smith. For each deficiency, indicate whether:

S. Smith's review note is correct
M. Mary's draft is correct
B. Both Smith's review note and Mary's draft are incorrect

Smith's Review Notes

1. An explanatory paragraph is required between the scope and opinion paragraphs is required for the change in accounting principles referring the reader to Note 10.

2. The names of the other auditors do not need to be explicitly stated in the introductory paragraph. Only that "other auditors" performed the audit and provided their report.

3. The opinion paragraph should extend the auditor's opinion beyond financial position to include the results of Concord's operations and flows.

4. The reference to the uncertainty in the opinion paragraph is incomplete. It should describe the nature of the uncertainty as pertaining to the grand jury investigation into possible violations of federal antitrust laws.

5. The explanatory paragraph following the opinion paragraph does not include the terms "substantial doubt" and "going concern". These terms are required to be used in this paragraph.

6. The explanatory paragraph following the opinion paragraph includes an inappropriate statement that "the consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty." This statement is misleading and should be omit

ted.
Answer:
1. B
2. S
3. S
4. B
5. S
6. M
Terms: Deficiencies in audit reports
Diff: Challenging
Objective: LO 3-1, LO 3-4, and LO 3-7
AACSB: Analytic skills

20) In auditing the long-term investments account, Arens, CPA, is unable to obtain audited financial statements for an investee located in a foreign country. Levine concludes sufficient appropriate audit evidence regarding this investment cannot be obtained.

For each of the following situations below, identify the appropriate opinion type and report modification by selecting a choice from the appropriate tables below.

Situation	Opinion Type	Intro	Scope	Opinion	Exp1
1. Assume the potential effect on the financial statements is immaterial.					
2. Assume the potential effect on the financial statements is moderate.					
3. Assume the potential effect on the financial statements is high.					

Opinion Type	Standard Paragraph Choice	Explanatory Paragraph
U Unqualified	O Omit	0 None required
Q Qualified	N No change	+ Insert before opinion
A Adverse	M Modify	- Insert after opinion
D Disclaimer		

Answer:

Situation	Opinion Type	Intro	Scope	Opinion	Exp1
1. Assume the potential effect on the financial statements is immaterial.	U	N	N	N	0
2. Assume the potential effect on the financial statements is moderate.	Q	N	M	M	+
3. Assume the potential effect on the financial statements is high.	D	O→ M	M	M	+

Terms: Circumstances and required audit reports
Diff: Challenging
Objective: LO 3-1, LO 3-4, and LO 3-7
AACSB: Analytic skills

21) Audit situations 1 through 10 present various independent factual situations an auditor might encounter in conducting an audit. List A represents the types of opinions the auditor ordinarily would issue, and List B represents the report modifications (if any) that would be necessary. For each situation, select one response from List A and one from List B. Select, as the best answer for each item, the action the auditor normally would take. Items from either list may be selected once, more than once, or not at all.

Assume the following:
- The auditor is independent
- The auditor previously expressed an unqualified opinion on the prior-year financial statements unless otherwise noted
- Only single-year (not comparative) statements are presented for the current year (unless otherwise stated)
- The conditions for an unqualified opinion exist unless contradicted in the factual scenario
- The conditions stated in the factual scenario are material
- No report modifications are to be made except in response to the factual scenario

Factual Scenario
1. The financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with GAAP.
2. In auditing the Long-Term Investments account, an auditor is unable to obtain audited F/S for an investee located in a foreign country. The auditor concludes that sufficient competent evidential matter regarding this investment cannot be obtained but it is not pervasive to the financials as a whole.
3. Due to recurring operating losses and working capital deficiencies the auditor has substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. However, the F/S disclosures are adequate.
4. The principal auditor decides to refer to the work of another auditor, who audited a wholly owned subsidiary of the entity and issued an unqualified opinion.
5. An entity issues F/S that present financial position and results of operations but omits the related statement of cash flows. Management discloses in the notes to the F/S that it does not believe the statement of cash flows to be useful.
6. An entity changes its depreciation method for production equipment from SL to units of production based on hours of utilization. The auditor concurs with the change, although it has a material effect on the comparability of the entity's F/S.
7. An entity is a defendant in a lawsuit alleging infringement of certain patent rights. However, management. cannot reasonably estimate the ultimate outcome of the litigation. The auditor believes that there is a reasonable possibility of a significant material loss, but the lawsuit is adequately disclosed in the notes to the F/S.
8. An entity discloses certain lease obligations in the notes to the F/S. The auditor believes that the failure to capitalize these leases is a departure from GAAP.
9. The entity wishes to show comparative F/S and include the prior year. However, the prior year F/S contained a qualification due to an inappropriate method of GAAP. Accordingly, management. corrected the prior year GAAP deficiency and included the updated numbers in the comparative financials for the current year.
10. The entity wishes to show comparative F/S and include the prior year. However, the prior year F/S were audited by another auditor who refuses to reissue his opinion.

List A Opinion Choices	List B Report Modification Choices
A Qualified	H Describe the circumstances in an explanatory paragraph *preceding* the opinion paragraph w/o modifying the three standard paragraphs.
B Unqualified	I Describe the circumstances in the opinion paragraph w/o adding an explanatory paragraph.
C Adverse	J Describe the circumstances in an explanatory paragraph *preceding* the opinion paragraph and modify the opinion paragraph.
D Disclaimer	K Describe the circumstances in an explanatory paragraph *following* the opinion paragraph and modify the opinion paragraph.
E Either Qualified or Adverse	L Describe the circumstances in an explanatory paragraph *preceding* the opinion paragraph and modify the scope & opinion paragraph.
F Either Disclaimer or Adverse	M Describe the circumstances in an explanatory paragraph *following* the opinion paragraph and modify the scope & opinion paragraph.
G Either Qualified or Disclaimer	N Describe the circumstances in the scope paragraph w/o adding an explanatory paragraph.
	O Describe the circumstances in an explanatory paragraph *following* the opinion paragraph w/o modifying the three standard paragraphs.
	P Describe the circumstances in the introductory paragraph w/o adding an explanatory paragraph.
.	Q Describe the circumstances in the introductory paragraph w/o adding an explanatory paragraph, and modify the scope & opinion paragraphs.
	R Issue the standard auditor's report w/o modification.
	S None of the above.

Answer:
1. B, R
2. A, L
3. B, I
4. B, Q
5. A, J
6. B, I
7. B, R
8. E, J
9. B, H
10. B, R
Terms: Audit situations and required reports with modifications
Diff: Challenging
Objective: LO 3-1, LO 3-4, LO 3-5, and LO 3-7
AACSB: Analytic skills

22) Financial statement users are typically more concerned with an unqualified report with explanatory paragraphs than they are with a disclaimer of opinion.
A) True
B) False
Answer: B
Terms: Financial statement users; Unqualified report with explanatory paragraphs; Disclaimer of opinion
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

23) A lack of independence will override any other scope limitations and requires a disclaimer of opinion.
A) True
B) False
Answer: A
Terms: Lack of independence; Disclaimer of opinion
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

24) When a qualified opinion is issued, an explanatory paragraph is added immediately after the opinion paragraph to explain the nature of the qualification that affects the opinion.
A) True
B) False
Answer: B
Terms: Qualified opinion explanatory paragraph and opinion paragraph
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

25) In the case of a disclaimer due to lack of independence, the entire scope paragraph is excluded from the report.
A) True
B) False
Answer: A
Terms: Disclaimer of opinion
Diff: Moderate
Objective: LO 3-7
AACSB: Reflective thinking skills

Learning Objective 3-8

1) When accounting principles are not consistently applied, and the materiality level is immaterial, the auditor will issue a(n):
A) unqualified opinion.
B) unqualified opinion with an explanatory paragraph.
C) adverse opinion.
D) disclaimer opinion.
Answer: A
Terms: Audit report and different levels of materiality
Diff: Moderate
Objective: LO 3-8
AACSB: Analytic skills

2) The first step to be followed when deciding the appropriate audit report in a given set of circumstances is to:
A) decide the appropriate type of report for the condition.
B) write the report.
C) determine whether any conditions exists requiring a departure from a standard unqualified report.
D) decide the materiality for each condition.
Answer: C
Terms: Auditor's decision process for audit reports
Diff: Moderate
Objective: LO 3-8
AACSB: Reflective thinking skills

3) In most audits, the auditor issues a:
A) qualified audit report.
B) unqualified audit report.
C) scope limited audit report.
D) adverse audit report.
Answer: B
Terms: Standard unqualified audit report
Diff: Challenging
Objective: LO 3-8
AACSB: Reflective thinking skills

4) More than one modification should be included in the audit report when:
A) the auditor is not independent and the auditor knows that the company has not followed generally accepted accounting principles.
B) there is substantial doubt about the going concern of the company and information about the causes of the uncertainties is not adequately disclosed in the footnotes.
C) there is a scope limitation and there is substantial doubt about the company's ability to continue as a going concern.
D) all of the above.
Answer: D
Terms: Standard report; More than one condition requiring a departure or modification
Diff: Moderate
Objective: LO 3-8
AACSB: Reflective thinking skills

5) When there is a justified departure from GAAP which is considered material, the auditor should issue a(n):
A) standard unqualified audit report.
B) disclaimer of opinion.
C) unqualified audit report with an explanatory paragraph.
D) adverse opinion.
Answer: C
Terms: Audit report and different levels of materiality
Diff: Moderate
Objective: LO 3-8
AACSB: Reflective thinking skills

6) If there is a deviation in the statements' preparation in accordance with GAAP and another accounting principle was applied on a basis that was not consistent with that of the preceding year:
A) the auditor must choose which modification to include in the audit report.
B) only the most material modification can be disclosed.
C) more than one modification should be included in the report.
D) none of the above.
Answer: C
Terms: Standard report; More than one condition requiring a departure or modification
Diff: Moderate
Objective: LO 3-8
AACSB: Reflective thinking skills

7) After the auditor determines whether any conditions exist which require a departure from a standard unqualified report, the next step in the decision process for audit reports is to:
A) write the report.
B) decide the materiality for each condition.
C) decide the appropriate type of report for the condition.
D) discuss the report with management.
Answer: B
Terms: Auditor's decision process for audit reports
Diff: Easy
Objective: LO 3-8
AACSB: Reflective thinking skills

8) The final step in the auditor's decision process for audit reports is to write the audit report.
A) True
B) False
Answer: A
Terms: Auditor's decision process for audit reports
Diff: Easy
Objective: LO 3-8
AACSB: Reflective thinking skills

9) Academic research is underway to study the effectiveness of communications provided by auditors in the audit report.
A) True
B) False
Answer: A
Terms: Research underway on audit report
Diff: Moderate
Objective: LO 3-8
AACSB: Reflective thinking skills

Learning Objective 3-9

1) Auditing standards in the United States allow an auditor to perform an audit of a U.S. entity in accordance with both generally accepted auditing standards in the U.S. and the ISAs.
A) True
B) False
Answer: A
Terms: Auditing standards of United States and International Standards of Auditing
Diff: Moderate
Objective: LO 3-9
AACSB: Reflective thinking skills