

***Auditing and Assurance Services, 15e, Global Editions (Arens)***  
**Chapter 8 Audit Planning**

Learning Objective 8-1

1) A measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unqualified opinion has been issued is the:

- A) inherent risk.
- B) acceptable audit risk.
- C) statistical risk.
- D) financial risk.

Answer: B

Terms: Measure of how willing auditor is to accept that the financial statements may be materially misstated after audit is completed

Diff: Easy

Objective: LO 8-1

AACSB: Reflective thinking skills

2) A measure of the auditor's assessment of the likelihood that there are material misstatements in an account before considering the effectiveness of the client's internal control is called:

- A) control risk.
- B) acceptable audit risk.
- C) statistical risk.
- D) inherent risk.

Answer: D

Terms: A measure of auditor's assessment of likelihood that there are material misstatements in an account before considering internal control

Diff: Easy

Objective: LO 8-1

AACSB: Reflective thinking skills

3) When inherent risk is high, there will need to be:

A)

A lower assessment of audit risk	More evidence accumulated by the auditor
Yes	Yes

B)

A lower assessment of audit risk	More evidence accumulated by the auditor
No	No

C)

A lower assessment of audit risk	More evidence accumulated by the auditor
Yes	No

D)

A lower assessment of audit risk	More evidence accumulated by the auditor
No	Yes

Answer: D

Terms: Inherent risk is high

Diff: Moderate

Objective: LO 8-1

AACSB: Reflective thinking skills

4) In what order should the following steps occur?

A. Assess client business risk

B. Understand the client's business and industry

C. Perform preliminary analytical procedures

D. Assess acceptable audit risk

A) D, B, C, A

B) B, A, C, D

C) B, D, A, C

D) D, C, B, A

Answer: B

Terms: Steps in planning an audit

Diff: Moderate

Objective: LO 8-1

AACSB: Reflective thinking skills

5) The auditor uses knowledge gained from the understanding of the client's business and industry to assess:

- A) client business risk.
- B) control risk.
- C) inherent risk.
- D) audit risk.

Answer: A

Terms: First standard of fieldwork; Proper planning

Diff: Challenging

Objective: LO 8-1

AACSB: Analytic skills

6) There are three main reasons why an auditor should properly plan audit engagements. Discuss each of these reasons.

Answer: Three reasons why an auditor should properly plan audit engagements are:

- To enable the auditor to obtain sufficient competent evidence for the circumstances. This is essential for minimizing legal liability and maintaining a good profession reputation.
- To help keep audit costs reasonable. Given the competitive auditing environment, keeping costs reasonable helps the firm obtain and retain clients.
- To avoid misunderstandings with the client. This is important for good client relations.

Terms: Reasons auditor should properly plan audit engagement

Diff: Moderate

Objective: LO 8-1

AACSB: Reflective thinking skills

7) When an auditor decides there is higher inherent risk for an account, one potential effect is that more audit evidence will be required for that account.

- A) True
- B) False

Answer: A

Terms: Inherent risk

Diff: Easy

Objective: LO 8-1

AACSB: Reflective thinking skills

8) As acceptable audit risk is decreased, the likely cost of conducting an audit increases.

- A) True
- B) False

Answer: A

Terms: Acceptable audit risk

Diff: Easy

Objective: LO 8-1

AACSB: Reflective thinking skills

9) Obtaining sufficient appropriate evidence is essential if the CPA firm is to minimize legal liability.

A) True

B) False

Answer: A

Terms: Acceptable audit risk

Diff: Moderate

Objective: LO 8-1

AACSB: Reflective thinking skills

10) A 100 % audit risk is complete certainty.

A) True

B) False

Answer: B

Terms: Acceptable audit risk

Diff: Moderate

Objective: LO 8-1

AACSB: Reflective thinking skills

Learning Objective 8-2

1) One of the purposes of an engagement letter is to avoid misunderstandings with the client. This is important for:

A)

Good client relations	Facilitating high-quality work at a reasonable cost
Yes	Yes

B)

Good client relations	Facilitating high-quality work at a reasonable cost
No	No

C)

Good client relations	Facilitating high-quality work at a reasonable cost
Yes	No

D)

Good client relations	Facilitating high-quality work at a reasonable cost
No	Yes

Answer: A

Terms: Engagement letter

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

2) The auditor is likely to accumulate more evidence when the audit is for a company:

A)

Which has large amounts of debt	Which is to be sold in the near future
Yes	Yes

B)

Which has large amounts of debt	Which is to be sold in the near future
No	No

C)

Which has large amounts of debt	Which is to be sold in the near future
Yes	No

D)

Which has large amounts of debt	Which is to be sold in the near future
No	Yes

Answer: A

Terms: Auditors accumulate more evidence when audit is for company

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

3) Initial audit planning involves four matters. Which of the following is **not** one of these?

A) Develop an overall audit strategy.

B) Request that bank balances be confirmed.

C) Schedule engagement staff and audit specialists.

D) Identify the client's reason for the audit.

Answer: B

Terms: Initial audit planning

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

4) Smith, CPA has requested permission to communicate with the predecessor auditor in order to review certain workpapers for high risk accounts for a new audit client. The new audit client's refusal to allow this communication to occur would impact Rodgers decision concerning:

- A) the auditor's ability to design audit tests.
- B) possible scope exception due to lack of access.
- C) the desirability of accepting the prospective engagement.
- D) violation of the GAAP rules concerning consistency and comparability of financial information.

Answer: C

Terms: New audit clients refusal to allow communication between predecessor and successor auditors

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

5) A successor auditor may perform which of the following for a new audit client?

A)

Speak to local attorneys, banks and other businesses regarding the company's reputation	Speak to the predecessor auditors about disagreements they had with management
Yes	Yes

B)

Speak to local attorneys, banks and other businesses regarding the company's reputation	Speak to the predecessor auditors about disagreements they had with management
No	No

C)

Speak to local attorneys, banks and other businesses regarding the company's reputation	Speak to the predecessor auditors about disagreements they had with management
Yes	No

D)

Speak to local attorneys, banks and other businesses regarding the company's reputation	Speak to the predecessor auditors about disagreements they had with management
No	Yes

Answer: A

Terms: Successor auditor may perform communication for new audit client

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

6) When dealing with audit risk:

- A) audit risk should not be a factor when determining if a new client should be accepted.
- B) audits with a low acceptable audit risk generally result in lower audit fees.
- C) if management of a company has a reputation of integrity, but is also known to take aggressive financial risks, the auditor should not accept the company as a new client.
- D) if the auditor concludes that acceptable audit risk is low, but the client is still acceptable, the auditor may still accept the engagement but increase the audit fee.

Answer: D

Terms: Lower acceptable audit risk

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

7) A written understanding detailing what the auditors will do in determining if the financial statements are fair representations of the company's financial statements and what the auditor expects from the client in performing an audit will normally be expressed in the:

- A) management letter requested by the auditor.
- B) engagement letter.
- C) Audit Plan.
- D) Audit Strategy for the client.

Answer: B

Terms: Written understanding detailing what auditor will do and what auditor expects from client in performing audit

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

8) If an auditor is requested to perform nonaudit services for a public company audit client, who is responsible for agreeing to those services with the audit firm?

- A) The client's management
- B) The client's chief executive officer
- C) The client's chief financial officer
- D) The client's audit committee

Answer: D

Terms: Responsibility for agreeing nonaudit services for a public company audit client

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

Topic: SOX

9) Which of the following statements is true regarding communications between predecessor and successor auditors?

- A) The burden of initiating the communication rests with the predecessor.
- B) The predecessor's response can be limited to stating that no information will be provided.
- C) The predecessor should communicate with the successor only if the client is public.
- D) The predecessor auditor of a public company does not need permission from the client before communicating with the successor auditor.

Answer: B

Terms: Communications between predecessor and successor auditors

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

10) The purpose of an engagement letter is to:

- A) document the CPA firm's responsibility to external users of the audited financial statements.
- B) document the terms of the engagement.
- C) notify the audit staff of an upcoming engagement so that personnel scheduling can be facilitated.
- D) emphasize management's responsibility for approving the audit program.

Answer: B

Terms: Purpose of engagement letter

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

11) Written communication that the auditor will provide reasonable assurance for the detection of fraud is found in:

- A) engagement letter.
- B) representation letter.
- C) responsibility letter.
- D) client letter.

Answer: A

Terms: Written communication that auditor will provide reasonable assurance

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

12) Which of the following normally signs the engagement letter for an audit of a private company?

- A) Management
- B) Board of directors representative
- C) Audit committee representative
- D) Corporate treasurer

Answer: A

Terms: Normally signs engagement letter for audit of private company

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

- 13) The two major factors affecting acceptable audit risk are:
- A) inherent risk and the intended uses of the financial statements.
  - B) control risk and the intended uses of the financial statements.
  - C) the likely statement users and the intended uses of the statements.
  - D) the audit firm and the intended uses of the statements

Answer: C

Terms: Audit risk

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

- 14) An engagement letter sent to a publicly held audit client usually would **not** include a:
- A) reference to the auditor's responsibility for the detection of errors or irregularities.
  - B) estimation of the time to be spent on the audit work by audit staff and management.
  - C) statement that management advisory services would be made available upon request.
  - D) reference to management's responsibility for the financial statements.

Answer: C

Terms: Engagement letter sent to publicly held client

Diff: Challenging

Objective: LO 8-2

AACSB: Reflective thinking skills

- 15) The preliminary audit strategy:
- A) is set before the auditor understands the client's reasons for the audit.
  - B) guides the development of the audit plan.
  - C) is determined after the engagement staffing is set.
  - D) is the detailed steps to be followed for the substantive audit tests.

Answer: B

Terms: Audit strategy

Diff: Moderate

Objective: LO 8-2

AACSB: Analytic skills

- 16) The purpose of the requirement in having communication between the predecessor and successor auditors is to:
- A) allow the predecessor to disclose information which would otherwise be confidential.
  - B) help the successor auditor to evaluate whether to accept the engagement.
  - C) help the client by facilitating the change of auditors.
  - D) ensure the predecessor collects all unpaid fees prior to a change in auditor.

Answer: B

Terms: Purpose of having communication between predecessor and successor audit

Diff: Challenging

Objective: LO 8-2

AACSB: Reflective thinking skills

17) The predecessor auditor is required to respond to the request of the successor auditor for information, but the response can be limited to stating that no information will be provided when:

- A) the predecessor auditor has poor relations with the successor auditor.
- B) the client is dissatisfied with the predecessor's work.
- C) there are actual or potential legal problems between the client and the predecessor.
- D) the predecessor believes that the client lacks integrity.

Answer: C

Terms: Predecessor auditor respond to request of successor auditor for information

Diff: Challenging

Objective: LO 8-2

AACSB: Reflective thinking skills

18) Which of the following best expresses the understanding of the terms of the engagement that exist between the client and the CPA firm?

- A) Management asserts there are no errors, material or immaterial, in the general ledger.
- B) Auditors assert that the primary audit goal is audit efficiency.
- C) Auditors assert that their primary responsibility is to plan and perform the audit in order to provide reasonable assurance as to the detection of material misstatement due to error or fraud.
- D) Management asserts that they will provide the auditor with a risk assessment as to material misstatements due to errors or fraud in the company's financial statements.

Answer: C

Terms: Understand responsibilities of the auditor and company for the audit

Diff: Challenging

Objective: LO 8-2

AACSB: Reflective thinking skills

19) When selecting staff for the audit engagement:

- A) only staff members who are CPAs should be assigned to the audit.
- B) only managers and above need to have appropriate competence and capabilities to perform the audit.
- C) continuity of staff members from year to year should not be a factor.
- D) staff assigned to the audit must be knowledgeable about the client's industry.

Answer: D

Terms: Selection of audit staff for engagement

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

20) An auditor who accepts an audit engagement and does not possess the industry expertise of the business entity should:

- A) engage financial experts familiar with the nature of the business entity.
- B) obtain a knowledge of matters that relate to the nature of the entity's business.
- C) refer a substantial portion of the audit to another CPA who will act as the principal auditor.
- D) first inform management that an unqualified opinion cannot be issued.

Answer: B

Terms: Auditor accepts audit engagement and does not possess industry expertise

Diff: Challenging

Objective: LO 8-2

AACSB: Reflective thinking skills

21) Which is usually included in an engagement letter?

A)

Estimate of hours required to complete audit	Dollar estimate of fees to be billed to the client
Yes	Yes

B)

Estimate of hours required to complete audit	Dollar estimate of fees to be billed to the client
No	No

C)

Estimate of hours required to complete audit	Dollar estimate of fees to be billed to the client
Yes	No

D)

Estimate of hours required to complete audit	Dollar estimate of fees to be billed to the client
No	Yes

Answer: D

Terms: Engagement letter

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

22) Which is usually included in an engagement letter?

A)

A reference to standards acceptable in the United States of America	A reference to GAAS
Yes	Yes

B)

A reference to standards acceptable in the United States of America	A reference to GAAS
No	No

C)

A reference to standards acceptable in the United States of America	A reference to GAAS
Yes	No

D)

A reference to standards acceptable in the United States of America	A reference to GAAS
No	Yes

Answer: A

Terms: Engagement letter

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

23) Which is usually included in an engagement letter?

A)

The financial statements are the responsibility of the company's management	Ratios to be used by the auditor in the planning phase
Yes	Yes

B)

The financial statements are the responsibility of the company's management	Ratios to be used by the auditor in the planning phase
No	No

C)

The financial statements are the responsibility of the company's management	Ratios to be used by the auditor in the planning phase
Yes	No

D)

The financial statements are the responsibility of the company's management	Ratios to be used by the auditor in the planning phase
No	Yes

Answer: C

Terms: Engagement letter

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

24) When may the auditor refer to a specialist in the audit report?

A)

Only if the specialist's report results in a modification of the audit opinion	Only if the specialist assisted in the audit of an account material to the financial statements
Yes	Yes

B)

Only if the specialist's report results in a modification of the audit opinion	Only if the specialist assisted in the audit of an account material to the financial statements
No	No

C)

Only if the specialist's report results in a modification of the audit opinion	Only if the specialist assisted in the audit of an account material to the financial statements
Yes	No

D)

Only if the specialist's report results in a modification of the audit opinion	Only if the specialist assisted in the audit of an account material to the financial statements
No	Yes

Answer: C

Terms: Auditors refer to specialist in audit report

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

25) Which is usually included in the engagement letter?

A)

The projected type of opinion on the financials statement to be audited	Name(s) of the client personnel responsible for supplying the auditor with information
Yes	Yes

B)

The projected type of opinion on the financials statement to be audited	Name(s) of the client personnel responsible for supplying the auditor with information
No	No

C)

The projected type of opinion on the financials statement to be audited	Name(s) of the client personnel responsible for supplying the auditor with information
Yes	No

D)

The projected type of opinion on the financials statement to be audited	Name(s) of the client personnel responsible for supplying the auditor with information
No	Yes

Answer: B

Terms: Engagement letter

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

26) Which is usually included in the engagement letter?

A)

List of audit procedures to be used in inventory observation	The auditors' assessment of Audit Risk
Yes	Yes

B)

List of audit procedures to be used in inventory observation	The auditors' assessment of Audit Risk
No	No

C)

List of audit procedures to be used in inventory observation	The auditors' assessment of Audit Risk
Yes	No

D)

List of audit procedures to be used in inventory observation	The auditors' assessment of Audit Risk
No	Yes

Answer: B

Terms: Engagement letter

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

27) Discuss the factors an auditor should consider before accepting a company as an audit client.

Answer: The auditor should investigate and consider the prospective client's standing in the business community, financial stability, management's integrity, and relations with its bankers, attorneys, and previous CPA firm. The auditor should also determine whether he or she possesses the required competence and independence to do the audit.

Terms: Factors to consider before accepting audit client

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

28) Discuss the primary purpose of an audit engagement letter. Is an engagement letter required?

Answer: The purpose of an audit engagement letter is to establish a clear understanding between the auditor and the client regarding the terms of the engagement. An engagement is required for both public and private company audits.

Terms: Engagement letter

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

29) Discuss the essential activities involved in the initial planning of an audit.

Answer: There are four essential activities involved in the initial planning of an audit. These are:

1. Client acceptance or continuation. In the case of a new client, the auditor must determine whether the client is one with which they wish to be associated with. In the case of a continuing client, an auditor must determine whether continuing the relationship is appropriate and in the firm's best interest.
2. The auditor should identify why the client wants or needs an audit. The auditor should determine the reason for the audit as soon as practical. The remainder of the planning activities may be impacted by the client's reason for requesting the audit.
3. Obtain an understanding with the client about the terms of the engagement. An understanding with the client should be obtained to avoid misunderstandings. Auditors are required to obtain an understanding with their clients. This understanding must be written.
4. Develop an overall audit strategy. The strategy should consider the reasons for the audit, including engagement staffing and any required audit specialists. Setting a strategy helps the auditor determine the resources required for the engagement.

Terms: Essential activities involved in initial planning of audit

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

30) Discuss the required communications between predecessor and successor auditors.

Answer: Auditing standards require a successor auditor to communicate with the predecessor auditor whenever accepting a client that has been previously audited. The purpose of the communication is to help the successor auditor evaluate whether to accept the engagement. While the burden of initiating the communication rests on the successor auditor, the predecessor auditor must respond to the request for information. However, because of the requirements related to confidentiality, the predecessor must obtain the former client's permission prior to providing information to the successor.

Terms: Required communications between predecessor and successor auditors

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

31) Discuss several reasons why an auditor may **not** wish to continue a relationship with an existing audit client.

Answer: There are a number of reasons an auditor may choose not to continue a relationship with an existing client. Examples include:

1. Previous conflicts over accounting issues, scope of the audit, type of opinion, or fees.
2. Management integrity may be deemed to be insufficient.
3. Legal action initiated by either the auditor or client related to prior audit services.
4. The presence of excessive risk which could result in financial failure of the client or lawsuits against the audit firm.

Terms: Reasons auditor may not wish to continue relationship with existing audit client

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

32) Discuss four of the matters that should be specified in an engagement letter.

Answer: Matters that should be specified in the engagement letter include:

- the objectives of the engagement.
- the responsibilities of the auditor and management.
- identification of the financial reporting framework used by management
- reference to the expected form and content of the audit report
- the engagement's limitation
- an agreement as to any other services to be provided.
- restrictions to be imposed on the auditor's work
- deadlines for completing the audit
- assistance to be provided by the client's personnel in obtaining records and documents and schedules to be prepared for the auditor
- agreement on fees
- auditor cannot guarantee that all acts of fraud will be discovered

Terms: Items included in engagement letter

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

33) Before accepting a new client, most CPA firms investigate the company to determine its acceptability. However, AICPA confidentiality requirements prohibit CPA firms from contacting certain parties—namely the company's attorneys and bankers—during this investigation.

A) True

B) False

Answer: B

Terms: Acceptance of new client

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

34) For prospective clients that have previously been audited by another CPA firm, the predecessor auditor is required to communicate with the successor auditor.

A) True

B) False

Answer: B

Terms: Communications between predecessor and successor auditors

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

35) When a successor auditor contacts a company's previous auditor, the predecessor auditor is required to respond fully and without limit to the request for information.

A) True

B) False

Answer: B

Terms: Communications between predecessor and successor auditors

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

36) A predecessor auditor who has been contacted by a successor auditor for information about the client does not have to obtain permission from the former client before providing any confidential information to the successor auditor because the confidentiality requirement does not extend to former clients.

A) True

B) False

Answer: B

Terms: Communications between predecessor and successor auditors

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

37) An auditor must evaluate a specialist's professional qualifications and understand the objectives of the specialist's work.

A) True

B) False

Answer: A

Terms: Auditor evaluate specialist's work

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

38) Because of audit risk, some CPA firms now refuse any new clients in certain high-risk industries.

A) True

B) False

Answer: A

Terms: Audit risk

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

39) An engagement letter establishes a clear understanding of the terms of the engagement between the client and the auditor, but it is optional for private companies.

A) True

B) False

Answer: A

Terms: Engagement letter

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

40) Because of the requirements of Rule 201 of the AICPA's *Code of Professional Conduct* which state that auditors should "undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence," auditors are not normally permitted to consult with, or rely on the work of, outside specialists during an audit engagement.

A) True

B) False

Answer: B

Terms: Use of outside specialists during audit engagement

Diff: Easy

Objective: LO 8-2

AACSB: Reflective thinking skills

41) If a prospective client has been audited in the past, the successor auditor will typically rely solely on the representations about the client by the predecessor auditor.

A) True

B) False

Answer: B

Terms: Communications between predecessor and successor auditors

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

42) A major consideration in audit staffing is the need for continuity from year to year.

A) True

B) False

Answer: A

Terms: Consideration in assigning staff to audit engagement

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

43) When a successor auditor requests information from a company's previous auditor, and there are legal problems or disputes between the client and the predecessor auditor, the predecessor auditor's response to the new auditor may be limited to stating that no information will be provided.

A) True

B) False

Answer: A

Terms: Communications between predecessor and successor auditors

Diff: Moderate

Objective: LO 8-2

AACSB: Reflective thinking skills

44) An engagement letter can affect the CPA firm's legal responsibilities to the client, but does not affect responsibility to external users of audited financial statements.

A) True

B) False

Answer: A

Terms: Engagement letter

Diff: Challenging

Objective: LO 8-2

AACSB: Reflective thinking skills

#### Learning Objective 8-3

1) In making client acceptance decisions, the audit firm will consider:

A) inherent and control risk of the client.

B) audit risk to the CPA Firm.

C) the client's business risk and the risk of material misstatements in the financial statements.

D) CPA Firm's potential ongoing revenue from the audit client.

Answer: C

Terms: Client acceptance decisions

Diff: Easy

Objective: LO 8-3

AACSB: Reflective thinking skills

2) Most auditors assess inherent risk as high for related parties and related-party transactions because:

A) of the unique classification of related-party transactions required on the balance sheet.

B) of the lack of independence between the parties.

C) of the unique classification of related-party transactions required on the income statement.

D) it is required by generally accepted accounting principles.

Answer: B

Terms: Inherent risk assessed high for relate parties and transactions

Diff: Easy

Objective: LO 8-3

AACSB: Reflective thinking skills

3) The audit team gathers information about a new client's business and industry in order to obtain:

- A) an understanding of the clients internal control system for financial reporting.
- B) an understanding of how economic events and transactions have an effect on the company's financial statements.
- C) information about control risk.
- D) information regarding whether the company is engaging in financial statement fraud.

Answer: B

Terms: Information about new client's business and industry

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

4) The auditor determines that Mathews Company occupies the 3<sup>rd</sup> floor of an office tower for which it pays no rent. The most likely explanation is:

- A) they got lucky the landlord hasn't noticed the lack of payments.
- B) landlord has weak internal controls over billings.
- C) a related party transaction in which a major shareholder owns the office tower.
- D) Matthews Company is engaging in fraudulent activities.

Answer: C

Terms: Auditor determines client occupies office for which it pays no rent

Diff: Moderate

Objective: LO 8-3

AACSB: Analytic skills

5) An official record of meetings of the board of directors and stockholders is included in the corporate:

- A) bylaws.
- B) charter.
- C) minutes.
- D) license.

Answer: C

Terms: Official record of meetings of board of directors and stockholders

Diff: Easy

Objective: LO 8-3

AACSB: Reflective thinking skills

6) A related party transaction may be indicated when another company:

- A) subsidizes certain operating expenses of the company.
- B) purchases its securities at their fair value.
- C) loans to company at market rates.
- D) has had a distributor relationship with the company for 10 years.

Answer: A

Terms: Related party transactions

Diff: Moderate

Objective: LO 8-3

AACSB: Analytic skills

7) Which of the following is **not** a primary reason for obtaining a good understanding of the client's industry and external environment?

A) Risk associated with a specific industry may affect the auditor's assessment of client business risk.

B) Risk associated with a specific industry may affect the auditor's assessment of acceptable audit risk.

C) Risk associated with a specific industry may affect the auditor's assessment of acceptable control risk.

D) Many control risks are common to all clients in certain industries.

Answer: C

Terms: Inherent risk factor

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

8) An auditor should examine minutes of the board of directors' meetings:

A) through the date of the financial statements.

B) through the date of the audit report.

C) only at the beginning of the audit.

D) on a test basis.

Answer: B

Terms: Minutes of the board of directors' meetings

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

9) Which of the following would most likely **not** be classified as a related-party transaction?

A) An advance of one week's salary to an employee

B) Sales of merchandise between affiliated companies

C) Loans or credit sales to the principal owner of the client company

D) Exchanges of equipment between two companies owned by the same person

Answer: A

Terms: Related-party transaction

Diff: Challenging

Objective: LO 8-3

AACSB: Reflective thinking skills

10) Which of the following best describes the corporate minutes of an entity?

A) Official record of the meetings of the board of directors and the stockholders

B) Unofficial record of the meeting of the board of directors

C) Official record of management meeting with investors and creditors of the company

D) Unofficial record of the board of directors meetings

Answer: A

Terms: Corporate minutes

Diff: Easy

Objective: LO 8-3

AACSB: Reflective thinking skills

11) Related party:

- A) transactions must be disclosed in the footnotes even if the amounts are immaterial.
- B) disclosures include the nature of the related party relationship and a description of the transaction.
- C) transactions are considered arms-length transactions.
- D) disclosures are required only for public companies.

Answer: B

Terms: Related party transactions

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

12) Define the term "related party" and discuss why an auditor should identify the client's related parties early in the audit.

Answer: A related party is an affiliated company, principal owner of the client company, or any other party with which the client deals where one of the parties can influence the management or operating policies of the other. Auditors need to be aware of who the client's related parties are early in the audit to enable the auditor to identify related-party transactions, especially those that have not been disclosed.

Terms: Related party

Diff: Easy

Objective: LO 8-3

AACSB: Reflective thinking skills

13) What documents do auditors routinely obtain to aid in their understanding of a client's governance system? Briefly discuss each of these documents.

Answer: Auditors commonly obtain organizational structure, code of ethics, and the minutes of meetings of the board of directors and shareholders. The organizational structure details the authority and duties among members of an organization. It indicates if the company is centralized or decentralized. Companies frequently communicate the entity's values and ethical standards through policy statements and codes of conduct. The corporate minutes are the official record of the meetings of the board of directors and stockholders. They include summaries of the most important topics discussed and decisions made at the board meetings.

Terms: Documents for client's governance system

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

14) What are three factors that have increased the importance of obtaining an understanding of a client's business and industry? How can an auditor obtain this understanding?

Answer: Factors that have increased the importance of obtaining an understanding of a client's business and industry include:

- Advances in information technology have increased connectivity among companies, customers, and vendors. Auditors must understand the risks associated with this increased connectivity.
- Recent significant declines in economic conditions around the world are likely to significantly increase a client's business risks. Auditors need to understand the nature of the client's business to understand the impact of major economic downturns on the client's financial statements and ability to continue as a going concern.
- Companies have expanded operations globally, often through joint ventures and strategic alliances.
- Information technology affects internal control processes, improving the quality and timeliness of accounting information.
- The increased importance of human capital and other intangible assets has increased accounting complexity and the importance of management judgments and estimates.
- Many clients have invested in complex financial instruments which may have declined in value, require complex accounting treatments, and often involve unknown counterparties who may create unexpected financial risks for the client.

Auditors consider these factors using a strategic systems approach to understand the client's business. The auditor can obtain a sound understanding of the client's business and industry through several means, including discussions with previous auditors and by reviewing the permanent files for the client; conferences with the client's personnel; studying AICPA industry audit guides, textbooks, technical magazines, and specialized journals; and by participating in industry associations and training programs.

Terms: Factors that increase the importance of obtaining an understanding of a client's business and industry

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

15) There are three primary reasons for obtaining a thorough understanding of the client's industry and external environment. What are these reasons?

Answer: The three reasons are:

- Risks associated with specific industries may affect the auditor's assessment of client business risk and acceptable audit risk.
- Certain inherent risks are typically common to all clients in certain industries. Familiarity with those risks aids the auditor in assessing their relevance to the client.
- Many industries have unique accounting requirements that the auditor must understand to evaluate whether the client's financial statements are in accordance with accounting standards.

Terms: Primary reasons for obtaining understanding client's industry and external environment

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

16) Auditors should obtain copies of the client's code of ethics and minutes of the meetings of the board of directors to aid in their understanding of the company's management and governance structure.

A) True

B) False

Answer: A

Terms: Code of ethics and board of directors' meeting minutes; Understanding of company management and governance structure

Diff: Easy

Objective: LO 8-3

AACSB: Reflective thinking skills

17) Many inherent risks are common to all clients in certain industries.

A) True

B) False

Answer: A

Terms: Inherent risk

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

18) Transactions with related parties must be disclosed in the financial statements if they are deemed to be material.

A) True

B) False

Answer: A

Terms: Related parties

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

19) All known related parties must be identified and included in the auditor's permanent files related to the client.

A) True

B) False

Answer: A

Terms: Related parties

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

20) Because of the lack of independence between related parties, the Sarbanes-Oxley Act prohibits all related party transactions.

A) True

B) False

Answer: B

Terms: Related parties

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

21) Management's philosophy and operating style influence the risk of material misstatements in the financial statements.

A) True

B) False

Answer: A

Terms: Management integrity

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

22) Ordinarily, the auditor should review corporate minutes during the later stages of an audit.

A) True

B) False

Answer: B

Terms: Corporate minutes

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

23) Material transactions between the client and the client's related parties must be disclosed in the auditor's report.

A) True

B) False

Answer: B

Terms: Material related party transactions

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

24) A tour of the client's facilities can help the auditor assess physical safeguards over assets and interpret accounting data related to assets such as factory equipment.

A) True

B) False

Answer: A

Terms: Business risk and factors that impact auditor's assessment

Diff: Moderate

Objective: LO 8-3

AACSB: Reflective thinking skills

## Learning Objective 8-4

1) An auditor has assessed client business risk and the risk of material misstatements to the clients financial statements. These are done in order to:

- A) apply the audit risk model to determine the appropriate extent of audit evidence.
- B) determine the reliance on the company's internal control systems for financial reporting.
- C) determine the test of balances to be performed by the audit team.
- D) assure the CPA firm that they can perform the audit effectively and efficiently.

Answer: A

Terms: Business risk and risk of material misstatements

Diff: Moderate

Objective: LO 8-4

AACSB: Reflective thinking skills

2) Business risk:

- A) is the risk after considering the effectiveness of top management controls.
- B) is the risk that the client's internal controls will fail.
- C) can include a new technology which threatens to erode a company's competitive advantage.
- D) cannot be mitigated by management.

Answer: C

Terms: Business risk

Diff: Moderate

Objective: LO 8-4

AACSB: Reflective thinking skills

3) Define business risk. List several factors that may impact the auditor's assessment of business risk.

Answer: Business risk is the risk that a company will fail to achieve its objectives.

Factors that may impact business risk include:

- General economic conditions,
- Significant declines in the economy that threaten the client's cash flows,
- New technology eroding a company's competitive advantage
- Company failing to execute its strategies as well as its competitors
- Extent of competition within an industry,
- Changing regulatory requirements,
- Competence of management,
- Ability to maintain sufficient cash flows and secure financing, and
- Successful implementation of business strategies.

Terms: Business risk and factors that impact auditor's assessment

Diff: Challenging

Objective: LO 8-4

AACSB: Reflective thinking skills

4) Management is the primary source for identifying client business risks.

A) True

B) False

Answer: A

Terms: Business risk

Diff: Easy

Objective: LO 8-4

AACSB: Reflective thinking skills

5) Sarbanes-Oxley encourages management to certify that it has informed the auditor and audit committee of any significant deficiencies in internal control.

A) True

B) False

Answer: B

Terms: Internal control

Diff: Easy

Objective: LO 8-4

AACSB: Reflective thinking skills

#### Learning Objective 8-5

1) Auditors perform preliminary analytical procedures to better understand the client's business and to assess client business risk.

A) True

B) False

Answer: A

Terms: Analytical procedures

Diff: Easy

Objective: LO 8-5

AACSB: Reflective thinking skills

2) In order to be meaningful, a company's ratios should be compared to their prior year's ratios, not industry benchmarks.

A) True

B) False

Answer: B

Terms: Analytical procedures

Diff: Easy

Objective: LO 8-5

AACSB: Reflective thinking skills

## Learning Objective 8-6

- 1) During audit planning, the auditor uses analytical procedures primarily to:
- A) identify weaknesses in internal control.
  - B) determine if the company's financial statements appear reasonable and are free of material misstatement.
  - C) determine the correspondence of the company's financial statements to the valuation and accuracy audit objectives.
  - D) determine the nature, extent, and timing of audit procedures.

Answer: D

Terms: Audit planning phase and primary purpose of analytical procedures

Diff: Moderate

Objective: LO 8-6

AACSB: Reflective thinking skills

- 2) Which of the following is most correct with respect to the use of analytical procedures?
- A) Analytical procedures may be used in evaluating balances in the testing phase as long as the auditor also uses them in assessing the going concern assumption.
  - B) Analytical procedures must be used throughout the audit.
  - C) Analytical procedures used in the testing phase of the audit are primarily used to direct an auditor's attention so that the auditor's understanding of the business is improved.
  - D) Analytical procedures are performed by studying plausible relationships between financial and nonfinancial data.

Answer: D

Terms: Use of analytical procedures

Diff: Challenging

Objective: LO 8-6

AACSB: Reflective thinking skills

- 3) Analytical procedures:
- A) are not a type of audit evidence.
  - B) are not required during the completion phase of the audit.
  - C) performed during the planning phase of the audit are used as a substantive test in support of account balances.
  - D) performed in the completion phase serve as a final review for material misstatements or financial problems.

Answer: D

Terms: Analytical procedures

Diff: Challenging

Objective: LO 8-6

AACSB: Reflective thinking skills

4) Discuss the four primary purposes of analytical procedures performed during the planning phase of an audit.

Answer: The four primary purposes of preliminary analytical procedures are:

- to help the auditor understand the client's industry and business,
- to help the auditor assess the going concern assumption,
- to indicate areas of possible misstatements, and
- to reduce the extent of detailed tests.

Terms: Primary purposes of analytical procedures

Diff: Moderate

Objective: LO 8-6

AACSB: Reflective thinking skills

5) Auditors routinely conduct analytical procedures in the planning, testing, and completion phases of the audit. Identify the primary and secondary purposes of performing analytical procedures in each phase of the audit.

Answer:

- Planning — primary purposes are to understand the client's business and industry and indicate possible misstatements. Secondary purposes are to assess going concern and reduce detailed tests.
- Testing — primary purpose is to reduce detailed tests and secondary purpose is to indicate possible misstatements
- Completion — primary purpose is to indicate possible misstatements and secondary purpose is to assess going concern

Terms: Primary and secondary purposes of analytical procedures in planning, testing, and completion phases of audit

Diff: Challenging

Objective: LO 8-6

AACSB: Reflective thinking skills

6) One purpose of performing preliminary analytical procedures in the planning phase of an audit is to help the auditor make a preliminary assessment of control risk.

A) True

B) False

Answer: B

Terms: Preliminary analytical procedures

Diff: Moderate

Objective: LO 8-6

AACSB: Reflective thinking skills

## Learning Objective 8-7

- 1) Which of the following is a correct statement regarding analytical procedures?
- A) A major strength in using industry ratios for auditing is the difference between the nature of the client's financial information and that of the firms making up the industry totals.
  - B) Common-size financial statements display all items as a percentage change from a base year.
  - C) Auditors should investigate the most significant differences between budgeted and actual results.
  - D) In order to look for a misstatement in the allowance for bad debts, the auditor should divide gross sales by sales returns and allowances.

Answer: C

Terms: Risk of material misstatement with accounting estimates

Diff: Easy

Objective: LO 8-7

AACSB: Reflective thinking skills

- 2) Which of the following would **not** be classified as an analytical procedure?
- A) Benchmarking the company's profitability ratios against others in the industry
  - B) Variance analysis of actual versus budgeted amounts for production
  - C) Reperforming the client's depreciation expense using the client's accounting policies for capital expenditures made during the year
  - D) Reconciling fixed asset dispositions with the fixed asset ledger

Answer: D

Terms: Analytical procedures

Diff: Moderate

Objective: LO 8-7

AACSB: Reflective thinking skills

- 3) Which of the following statements is **not** correct with respect to analytical procedures?
- A) Auditing standards emphasize the need for auditors to develop and use expectations.
  - B) Analytical procedures must be performed throughout the audit.
  - C) Analytical procedures may be performed at any time during the audit.
  - D) Analytical procedures use comparisons and relationships to assess whether account balances appear reasonable.

Answer: B

Terms: Analytical procedures

Diff: Moderate

Objective: LO 8-7

AACSB: Reflective thinking skills

4) When performing planning analytical procedures for a client the auditor detected that the gross profit percentage had declined by 50% from the previous year to the year currently under audit. The auditor should:

- A) investigate the possibility the client may have made an error in their cost of goods sold computation.
- B) assist management in developing greater cost efficiencies in their product line.
- C) prepare a going concern opinion for the client.
- D) advise the client to have extensive disclosure to alleviate investor concerns.

Answer: A

Terms: Analytical procedures in planning phase

Diff: Challenging

Objective: LO 8-7

AACSB: Reflective thinking skills

5) When are auditors likely to encounter judgment problems in the use of analytical procedures?

- A) Whenever the auditor places reliance on management's explanations for unusual fluctuations in account balances without first developing independent expectations
- B) Whenever the auditor allows unaudited balances to unduly influence his/her expectations of current balances
- C) Whenever the auditor fails to consider the pattern reflected by several unusual fluctuations when trying to explain what caused them
- D) The auditor is likely to encounter judgment problems in each of the above instances.

Answer: D

Terms: Judgment problems in use of analytical procedures

Diff: Challenging

Objective: LO 8-7

AACSB: Reflective thinking skills

6) The major concern when using nonfinancial data in analytical procedures is the:

- A) accuracy of the nonfinancial data.
- B) source of the nonfinancial data.
- C) type of nonfinancial data.
- D) presence of multiple sources of nonfinancial data.

Answer: A

Terms: Concern when using nonfinancial data in analytical procedures

Diff: Challenging

Objective: LO 8-7

AACSB: Reflective thinking skills

7) Whenever an auditor compares client data to client-prepared budgets, there are two special concerns. Indicate if the two items below are concerns.

A)

Assessing whether the budgets were realistic plans	Client data may have been altered to conform to the budget
A concern	A concern

B)

Assessing whether the budgets were realistic plans	Client data may have been altered to conform to the budget
Not a concern	Not a concern

C)

Assessing whether the budgets were realistic plans	Client data may have been altered to conform to the budget
A concern	Not a concern

D)

Assessing whether the budgets were realistic plans	Client data may have been altered to conform to the budget
Not a concern	A concern

Answer: A

Terms: Comparison of client data to client-prepared budgets

Diff: Challenging

Objective: LO 8-7

AACSB: Reflective thinking skills

Learning Objective 8-8

1) Which is a liquidity activity ratio?

A) Profit margin

B) Inventory turnover

C) Return on assets

D) Times interest earned

Answer: B

Terms: Liquidity ratio

Diff: Moderate

Objective: LO 8-8

AACSB: Reflective thinking skills

2) When using financial ratios, the most important comparisons are to those of previous years for the company and to industry averages or similar companies for the same year.

A) True

B) False

Answer: A

Terms: Common financial ratios

Diff: Easy

Objective: LO 8-8

AACSB: Reflective thinking skills

3) The most widely used profitability ratio is return on assets.

A) True

B) False

Answer: B

Terms: Common financial ratios

Diff: Easy

Objective: LO 8-8

AACSB: Reflective thinking skills

4) The quick ratio has the same denominator as the current ratio.

A) True

B) False

Answer: A

Terms: Common financial ratios

Diff: Easy

Objective: LO 8-8

AACSB: Reflective thinking skills