

1. The purpose of the audit is to increase the level of confidence that users of financial statements can place on financial statements.
True False
2. The auditing standards determine how an auditor describes if the procedures for an audit are present.
True False
3. Because client information is confidential (according to many state statutes), the predecessor auditor will not respond to the request for information about the client without the client's written permission.
True False
4. 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 or international financial reporting standards.
True False
5. In the planning stage, one of the objectives of the auditor is to identify and assess the risk of material misstatement.
True False
6. Relevant assertions are assertions made by the auditor about the financial statements of the company that have a reasonable possibility of containing a misstatement that would cause the statements to be misstated.
True False
7. A material misstatement is an error or fraud in the financial statements that might cause a user of the financial statements to change his opinion about the company.
True False
8. During the planning process, the auditor determines the overall audit strategy for the audit. This strategy establishes the scope, timing, and direction of the audit and guides the auditor when he prepares the audit plan.
True False
9. The auditor should document the audit strategy in the audit report containing the key decisions about the scope, timing, and conduct of the audit.
True False
10. The audit plan will be used to gather sufficient appropriate evidence to reduce audit risk to a near zero level.
True False
11. Audit risk determines the amount of evidence gathered. The amount of evidence gathered determines the audit fees.
True False
12. When an accounting firm establishes a system of quality control, the firm's objective is to obtain assurance that the firm complied with applicable legal and regulatory requirements.
True False

13. Which of the following statements is correct about the objective of the audit process?
- A Generally accepted auditing standards require the auditor to obtain assurance about whether the . financial statements are free from all misstatements.
 - B Reasonable assurance is obtained by the auditor when he has obtained sufficient appropriate audit . evidence to reduce audit risk to an acceptably low level.
 - C A misstatement is an error or fraud in the financial statements that might cause a user of the financial . statements to change his decision about the company.
 - D. Sufficient appropriate audit evidence refers to the persuasiveness of the evidence gathered.
14. Which of the following statements is correct about the objective of the audit process?
- A Generally accepted auditing standards require the auditor to obtain reasonable assurance about whether . the financial statements are free from material misstatements.
 - B Assurance is obtained by the auditor when he has obtained sufficient appropriate audit evidence to . reduce audit risk to an acceptably low level.
 - C A misstatement is an error or fraud in the financial statements that might cause a user of the financial . statements to change his decision about the company.
 - D. Sufficient appropriate audit evidence refers to the persuasiveness of the evidence gathered.
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 - B Assurance is obtained by the auditor when he has obtained sufficient appropriate audit evidence to . reduce audit risk to an acceptably low level.
 - C A misstatement is an error or fraud in the financial statements that might cause a user of the financial . statements to change his decision about the company.
 - D. Sufficient appropriate audit evidence refers to the quantity and quality of the evidence gathered.
17. Audit risk is defined as
- A. the risk that the auditor issues an opinion saying that the financial statements are not materially misstated when they are.
 - B. the risk that the auditor fails to issue an opinion saying that the financial statements are materially misstated when they are.
 - C. the risk that the auditor does not detect a material misstatement in the financial statements.
 - D the risk that the auditor does detect a material misstatement in the financial statements but fails to . report the material misstatement.
 - E. the risk that the auditor issues an opinion saying that the financial statements are materially misstated when they are not.
18. Which of the following are the three main parts of the audit process?
- A. (1) The planning process, (2) The testing process, and (3) The reporting process.
 - B. (1) The planning process, (2) The testing process, and (3) The decision process.
 - C. (1) The planning process, (2) The evaluation process, and (3) The decision process.
 - D. (1) The risk assessment process, (2) The testing process, and (3) The decision process.

19. The auditing standards describe how an auditor determines if the preconditions for an audit are present. Which of the following would be a precondition for an audit?
- A The auditor obtains the agreement of management that it acknowledges and understands its . responsibility for the issuing of the financial statements in accordance with the financial reporting framework.
- B The auditor obtains the agreement from management that it acknowledges and understands its . responsibility for internal controls so financial statements can be prepared free of material misstatement.
- C The auditor obtains the agreement of management that it agrees to provide the auditor with all . information that management is aware of that might be relevant to the preparation of the financial statements.
- D The auditor determines whether the financial reporting framework (the set of accounting standards) . used by the client to prepare the financial statements is acceptable.
20. The auditing standards describe how an auditor determines if the preconditions for an audit are present. Which of the following would be a precondition for an audit?
- A The auditor obtains the agreement of management that it acknowledges and understands its . responsibility for the preparation of the financial statements in accordance with the financial reporting framework.
- B The auditor obtains the agreement from management that it acknowledges and understands its . responsibility for internal controls so financial statements can be prepared free of material misstatement.
- C The auditor obtains the agreement of management that it agrees to provide the auditor with all . information that management is aware of that might be relevant to the preparation of the financial statements.
- D The auditor determines whether the financial reporting framework (the set of internal control standards) . used by the client to prepare the financial statements is acceptable.
21. The auditing standards describe how an auditor determines if the preconditions for an audit are present. Which of the following would be a precondition for an audit?
- A The auditor obtains the agreement of management that it acknowledges and understands its . responsibility for the issuing of the financial statements in accordance with the financial reporting framework.
- B The auditor obtains the agreement from management that it acknowledges and understands its . responsibility for internal controls so financial statements can be prepared free of misstatement.
- C The auditor obtains the agreement of management that it agrees to provide the auditor with all . information that management is aware of that might be relevant to the preparation of the financial statements.
- D The auditor determines whether the financial reporting framework (the set of internal control standards) . used by the client to prepare the financial statements is acceptable.
22. The auditing standards describe how an auditor determines if the preconditions for an audit are present. Which of the following would be a precondition for an audit?
- A The auditor obtains the agreement of management that it acknowledges and understands its . responsibility for the issuing of the financial statements in accordance with the financial reporting framework.
- B The auditor obtains the agreement from management that it acknowledges and understands its . responsibility for internal controls so financial statements can be prepared free of material misstatement.
- C The auditor obtains the agreement of management that it will provide the auditor with all information . that management is aware of that might be relevant to the preparation of the financial statements and any other information the auditor may request.
- D The auditor determines whether the financial reporting framework (the set of internal control standards) . used by the client to prepare the financial statements is acceptable.

23. Generally accepted auditing standards require the auditor to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptable level. If the auditor determines that he cannot comply with this standard due to the risk level present in the client before the engagement, he will
- A. reject the engagement.
 - B. advise the client on how to reduce the risk level.
 - C. increase substantive testing to reduce the risk to an acceptable level.
 - D. increase control testing to reduce the risk to an acceptable level.
24. When an auditor agrees to perform an audit because the preconditions for an audit have been met and the auditor believes that he can gather sufficient appropriate audit evidence to reduce audit risk to an acceptably low level, an engagement letter is prepared. The engagement letter includes:
- A. the purpose of the audit (to express an opinion on particular financial statements).
 - B. management's assistance (to prepare the financial statements, select accounting policies, establish effective internal controls, design programs to prevent and detect fraud, provide written representation, inform the auditor of subsequent events that may affect the financial statements, and make all financial records and information available to the auditor).
 - C. the auditor's responsibilities (to conduct the audit in accordance with generally accepted auditing standards and obtain an understanding of the client's internal control).
 - D. the internal control limitations of an audit engagement (material misstatements may not be detected).
25. When an auditor agrees to perform an audit because the preconditions for an audit have been met and the auditor believes that he can gather sufficient appropriate audit evidence to reduce audit risk to an acceptably low level, an engagement letter is prepared. The engagement letter includes:
- A. the objective and scope of the audit (to express an opinion on particular financial statements).
 - B. management's assistance (to prepare the financial statements, select accounting policies, establish effective internal controls, design programs to prevent and detect fraud, provide written representation, inform the auditor of subsequent events that may affect the financial statements, and make all financial records and information available to the auditor).
 - C. the auditor's performance (to conduct the audit in accordance with generally accepted auditing standards and obtain an understanding of the client's internal control).
 - D. the internal control limitations of an audit engagement (material misstatements may not be detected).
26. When an auditor agrees to perform an audit because the preconditions for an audit have been met and the auditor believes that he can gather sufficient appropriate audit evidence to reduce audit risk to an acceptably low level, an engagement letter is prepared. The engagement letter includes:
- A. the purpose of the audit (to express an opinion on particular financial statements).
 - B. management's responsibilities (to prepare the financial statements, select accounting policies, establish effective internal controls, design programs to prevent and detect fraud, provide written representation, inform the auditor of subsequent events that may affect the financial statements, and make all financial records and information available to the auditor).
 - C. the auditor's performance (to conduct the audit in accordance with generally accepted auditing standards and obtain an understanding of the client's internal control).
 - D. the internal control limitations of an audit engagement (material misstatements may not be detected).
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 - B. management's assistance (to prepare the financial statements, select accounting policies, establish effective internal controls, design programs to prevent and detect fraud, provide written representation, inform the auditor of subsequent events that may affect the financial statements, and make all financial records and information available to the auditor).
 - C. the auditor's performance (to conduct the audit in accordance with generally accepted auditing standards and obtain an understanding of the client's internal control).
 - D. the inherent limitations of an audit engagement (material misstatements may not be detected).

28. When an auditor agrees to perform an audit because the preconditions for an audit have been met and the auditor believes that he can gather sufficient appropriate audit evidence to reduce audit risk to an acceptably low level, an engagement letter is prepared. The engagement letter includes:
- A. arrangements regarding the planning and performance of the audit, including the composition of the audit team.
 - B. the basis on which fees are computed are based on an unqualified audit opinion.
 - C. arrangements concerning the opinions of other auditors and specialists in the audit.
 - D. arrangements concerning the opinions of internal auditors and other staff of the company.
 - E. arrangements to be made with the predecessor auditor in the case of a follow up audit.
29. When an auditor agrees to perform an audit because the preconditions for an audit have been met and the auditor believes that he can gather sufficient appropriate audit evidence to reduce audit risk to an acceptably low level, an engagement letter is prepared. The engagement letter includes:
- A. the basis on which fees are computed are based on an unqualified audit opinion.
 - B. arrangements regarding the methods of testing of the audit, including the composition of the audit team.
 - C. arrangements concerning the involvement of other auditors and specialists in the audit.
 - D. arrangements concerning the opinions of internal auditors and other staff of the company.
 - E. arrangements to be made with the predecessor auditor in the case of a follow up audit.
30. When an auditor agrees to perform an audit because the preconditions for an audit have been met and the auditor believes that he can gather sufficient appropriate audit evidence to reduce audit risk to an acceptably low level, an engagement letter is prepared. The engagement letter includes:
- A. the basis on which fees are computed are based on an unqualified audit opinion.
 - B. arrangements regarding the methods and testing of the audit, including the composition of the audit team.
 - C. arrangements concerning the opinions of other auditors and specialists in the audit.
 - D. arrangements concerning the involvement of internal auditors and other staff of the company.
 - E. arrangements to be made with the predecessor auditor in the case of a follow up audit.
31. When an auditor agrees to perform an audit because the preconditions for an audit have been met and the auditor believes that he can gather sufficient appropriate audit evidence to reduce audit risk to an acceptably low level, an engagement letter is prepared. The engagement letter includes:
- A. the basis on which fees are computed are based on an unqualified audit opinion.
 - B. arrangements regarding the methods of testing of the audit, including the composition of the audit team.
 - C. arrangements concerning the opinions of other auditors and specialists in the audit.
 - D. arrangements concerning the opinions of internal auditors and other staff of the company.
 - E. arrangements to be made with the predecessor auditor in the case of an initial audit.
32. In the request for information from the predecessor auditor, the new auditor may ask for information about the following item
- A. the integrity of management.
 - B. disagreements with management about the fee payment schedule.
 - C. communications to management regarding fraud and noncompliance with laws or regulations by the company.
 - D. communications to management and those charged with governance regarding significant deficiencies and material weaknesses in financial reporting.
33. In the request for information from the predecessor auditor, the new auditor may ask for information about the following item
- A. the integrity of those charged with governance.
 - B. disagreements with management about accounting policies or auditing procedures.
 - C. communications to management regarding fraud and noncompliance with laws or regulations by the company.
 - D. communications to management and those charged with governance regarding significant deficiencies and material weaknesses in financial reporting.

34. In the request for information from the predecessor auditor, the new auditor may ask for information about the following item
- A. the integrity of those charged with governance.
 - B. disagreements with management about the fee payment schedule.
 - C. communications to those charged with governance regarding fraud and noncompliance with laws or regulations by the company.
 - D. communications to management and those charged with governance regarding significant deficiencies and material weaknesses in financial reporting.
35. In the request for information from the predecessor auditor, the new auditor may ask for information about the following item
- A. the integrity of those charged with governance.
 - B. disagreements with management about the fee payment schedule.
 - C. communications to management regarding fraud and noncompliance with laws or regulations by the company.
 - D. the predecessor auditor's understanding regarding the reasons for the change of auditors.
36. When an auditor signs an engagement letter
- A. the auditor may commence the audit
 - B. the client has an obligation to pay the audit fee
 - C. the auditor has a contract to perform the audit
 - D. the client is attesting to the accuracy of the financial statements
37. Step 2 of the planning process is the risk assessment phase. At this stage of the planning process the objective of the auditor is to identify and assess the risk of material misstatement. The auditor does this by
- A. gaining an understanding of the company and its environment, including the company's internal controls
 - B. gaining an understanding of the company's industry, including the company's competition
 - C. developing an audit strategy to respond to the risk of material misstatement
 - D. determining risk assessment procedures to assess the risk of material misstatement at the financial statement and assertion level
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- A. gaining an understanding of the company and its management, including the company's financial controls
 - B. gaining an understanding of the company's industry, including the company's competition
 - C. determining materiality
 - D. determining risk assessment procedures to assess the risk of material misstatement at the financial statement and assertion level
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 - B. gaining an understanding of the company's industry, including the company's competition
 - C. developing an audit strategy to respond to the risk of material misstatement
 - D. performing risk assessment procedures to assess the risk of material misstatement at the financial statement and assertion level

40. How does the auditor gain an understanding of the entity and its environment? The auditing standards require the auditor to understand
- A. industry, regulatory and other external factors relevant to the entity
 - B. the nature of management of the entity, including its operations, ownership and governance structures, the types of investments management makes, and the way the entity is structured and financed
 - C. management's selection and use of accounting policies, including any changes in these policies
 - D. management's objectives and strategies and the related business risks that may lead to the risk of material misstatement
41. How does the auditor gain an understanding of the entity and its environment? The auditing standards require the auditor to understand
- A. industry, regulatory and other external factors that management deems relevant to the entity
 - B. the nature of the entity, including its operations, ownership and governance structures, the types of investments the entity makes, and the way the entity is structured and financed
 - C. management's selection and use of accounting policies, including any changes in these policies
 - D. management's objectives and strategies and the related business risks that may lead to the risk of material misstatement
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 - B. the nature of management of the entity, including its operations, ownership and governance structures, the types of investments management makes, and the way the entity is structured and financed
 - C. management's selection and use of accounting policies, including any changes in these policies
 - D. the entity's objectives and strategies and the related business risks that may lead to the risk of material misstatement
44. Internal controls are
- A. usually necessary to run the company
 - B. part of the environment of the client
 - C. implemented in areas where fraud risk is greatest
 - D. are only necessary if audit testing is going to rely on them
45. For internal controls that are relevant to the audit, the auditor should
- A. understand incentives of the company to misstate the financial statements
 - B. identify the relevant financial statement accounts with the greatest potential for misstatements
 - C. understand the design of the controls and the implementation of the controls
 - D. design audit procedures to determine that the accounts are fairly presented according to the applicable financial reporting framework
46. After the auditor determines materiality for the company, the auditor can determine
- A. the accounts where maximum audit testing is required
 - B. the level of misstatement necessary for the misstatement to be considered material
 - C. the value of clear and accurate financial disclosures
 - D. the auditor's responsibility to outside users of financial statements to provide financial information consistent with accounting regulations

47. The determination of materiality is based on
- A. generally accepted auditing standards
 - B. the likelihood of material misstatements being present
 - C. the professional judgment of the auditor
 - D. the understanding of the entity's internal controls
48. The auditing standards specify that misstatements are considered to be material if
- A. they individually or in the aggregate could reasonably be expected to influence the decisions of management
 - B. they could reasonably be expected to influence the decisions of knowledgeable users of the financial statements
 - C. the client determines that they could be expected to influence the decisions of outside users of the financial statements
 - D. they individually or in the aggregate could reasonably be expected to influence the decisions of users of the financial statements
49. Once the auditor calculates materiality, he uses the concept of materiality in
- A. determining the timing of substantive tests
 - B. planning and performing the audit
 - C. evaluating the effect of corrected misstatements on the financial statements
 - D. determining if there are any deficiencies in internal control
 - E. B and C
50. Once the auditor calculates materiality, he uses the concept of materiality
- A. to determine the timing of substantive tests
 - B. to determine the amount below which misstatements will always be evaluated as immaterial
 - C. to evaluate the effect of uncorrected misstatements on the financial statements
 - D. to determine if there are any deficiencies in internal control
51. In planning the audit, the auditor makes decisions about the size of misstatements that will be considered material. These decisions allow the auditor to
- A. determine the nature, timing, and extent of inherent risk assessment procedures
 - B. identify and assess the risk of misstatement
 - C. determine the nature, timing, and extent of audit procedures
 - D. establish an amount below which misstatements will always be evaluated as immaterial
 - E. C and D
52. In planning the audit, the auditor makes decisions about the size of misstatements that will be considered material. These decisions allow the auditor to
- A. determine the nature, timing, and extent of risk assessment procedures
 - B. identify and assess the risk of misstatement
 - C. determine the nature, timing, and extent of internal control procedures
 - D. establish an amount below which misstatements will always be evaluated as immaterial
 - E. A and D
53. In planning the audit, the auditor makes decisions about the size of misstatements that will be considered material. These decisions allow the auditor to
- A. determine the nature, timing, and extent of inherent risk assessment procedures
 - B. identify and assess the risk of material misstatement
 - C. determine the nature, timing, and extent of internal control procedures
 - D. establish an amount below which misstatements will always be evaluated as immaterial
54. In planning the audit, the auditor makes decisions about the size of misstatements that will be considered material. These decisions do not allow the auditor to
- A. determine the nature, timing, and extent of audit procedures
 - B. identify and assess the risk of material misstatement
 - C. determine the nature, timing, and extent of risk assessment procedures
 - D. establish an amount below which misstatements will always be evaluated as immaterial

55. In the planning process, the auditor assesses the risk that misstatements have occurred in the financial statements. The source of misstatements includes
- A. inaccuracies in gathering or processing data used to audit the financial statements
 - B. the use of auditing standards that may be unreasonable or inappropriate
 - C. differences between the amount or classification of a financial statement item and what should have been reported under generally accepted auditing standards
 - D. omissions of financial statement explanations
 - E. financial statement disclosures that are not in accordance with generally accepted accounting principles
56. In the planning process, the auditor assesses the risk that misstatements have occurred in the financial statements. The source of misstatements includes
- A. the use of auditing standards that the auditor may consider unreasonable or inappropriate
 - B. inaccuracies in gathering or processing data used to prepare the financial statements
 - C. differences between the amount or classification of a financial statement item and what should have been reported under generally accepted auditing standards
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 - B. inaccuracies in gathering or processing data used to prepare the financial statements
 - C. differences between the amount or classification of a financial statement item and what should have been reported under generally accepted accounting principles
 - D. omissions of financial statement items
 - E. financial statement disclosure that are not in accordance with generally accepted auditing standards
59. Which of the following is not a method that the auditor might use to calculate materiality?
- A. based on a decision rule that is a percentage of total sales
 - B. based on a decision rule that is a percentage of total expenses
 - C. based on a decision rule that is a percentage of pre-tax income or income from operations
 - D. based on a decision rule that is a percentage of total assets
60. To identify the risk of material misstatement, the auditor considers material misstatements at
- A. the financial statement level
 - B. the management assertion level
 - C. the relevant assertion level
 - D. the control risk level
 - E. A and C
61. The auditor can assign a portion of the materiality to individual accounts in the financial statements
- A. This is referred to as the auditor using professional judgment
 - B. This is referred to determining materiality for particular items on the financial statements
 - C. This is referred to as the tolerable misstatement or performance materiality for an account
 - D. This is referred to as the auditor obtaining reasonable assurance

62. The auditor designs the risk assessment procedures that he believes will be effective in assessing the risk of material misstatement for the entity. According to the auditing standards, the risk assessment process should include
- A. inquiries of management about the risk of material misstatement due to errors or fraud
 - B. tests of controls
 - C. observation of inventory
 - D. substantive test of transactions
63. The auditor designs the risk assessment procedures that he believes will be effective in assessing the risk of material misstatement for the entity. According to the auditing standards, the risk assessment process should include
- A. inquiries of management about the ability of the client to generate sufficient cash to repay debt
 - B. tests of controls
 - C. observation and inspection
 - D. substantive test of transactions
64. The auditor designs the risk assessment procedures that he believes will be effective in assessing the risk of material misstatement for the entity. According to the auditing standards, the risk assessment process should include
- A. internal control tests for significant accounts
 - B. analytical procedures
 - C. observation of inventory
 - D. substantive test of transactions
65. Which of the following is NOT correct about the audit discussion about the susceptibility of the entity's financial statements to material misstatement?
- A. the discussion must be done during the planning phase
 - B. the purpose of the discussion is to allow audit team members gain a better understanding of the potential for misstatement
 - C. the team determines the audit tests to mitigate the possibility of misstatements
 - D. the discussion must be documented in the work papers
66. Much of the information regarding material misstatement in the company is obtained from management. However, the auditor may find it useful to talk to employees at different levels of authority such as
- A. individuals charged with corporate governance
 - B. the personnel department responsible for hiring competent employees
 - C. in-house legal counsel regarding the risk of incorrect processing
 - D. employees in the shipping and receiving departments
67. Much of the information regarding material misstatement in the company is obtained from management. However, the auditor may find it useful to talk to employees at different levels of authority such as
- A. individuals charged with department governance
 - B. internal audit personnel who test internal controls
 - C. in-house legal counsel regarding the risk of incorrect processing
 - D. employees in the shipping or receiving departments
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- A. individuals charged with department governance
 - B. internal department personnel who perform internal controls
 - C. in-house legal counsel regarding the risk of litigation
 - D. employees in the shipping or receiving department
69. Much of the information regarding material misstatement in the company is obtained from management. However, the auditor may find it useful to talk to employees at different levels of authority such as
- A. individuals charged with department governance
 - B. internal department personnel who perform internal controls
 - C. in-house legal counsel regarding the risk of incorrect processing
 - D. employees involved in initiating, processing, or authorizing complex or unusual transactions

70. The auditor performs analytical procedures to
- A. increase his understanding of the business
 - B. identify expected changes between his expectations for the current year and the prior year
 - C. identify areas where he believes the risk of material misstatement might not be present
 - D. satisfy the requirement of the auditing standards to use analytical procedures during the testing stage
71. The auditor performs analytical procedures to
- A. increase his understanding of the accounting system
 - B. identify unexpected changes between his expectations for the current year and the prior year
 - C. identify areas where he believes the risk of material misstatement might not be present
 - D. satisfy the requirement of the auditing standards to use analytical procedures during the testing stage
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 - B. identify expected changes between his expectations for the current year and the prior year
 - C. identify areas where he believes the risk of material misstatement might not be present
 - D. satisfy the requirement of the auditing standards to use analytical procedures during the planning stage
74. Performing analytical procedures during the planning process allows the auditor to
- A. identify areas where client performance is inconsistent with its expectations
 - B. develop an audit program to gather evidence regarding internal controls for relevant assertions in significant accounts
 - C. schedule more time for substantive testing
 - D. schedule more time for testing of controls
75. Performing analytical procedures during the planning process allows the auditor to
- A. identify areas where client performance is consistent with its expectations
 - B. develop an audit program to gather evidence regarding financial statement areas that are most likely to be materially misstated
 - C. schedule more time for substantive testing
 - D. schedule more time for testing of controls
76. Observation may provide the auditor with useful information to support the information obtained from management and other employees related to the risk of material misstatement. The auditor might observe
- A. the entity's operations
 - B. documents, records and internal control assessments
 - C. decisions prepared by management
 - D. the entity's plans and office expenses
77. Observation and inspection may provide the auditor with useful information to support the information obtained from management and other employees related to the risk of material misstatement. The auditor might observe or inspect
- A. the entity's forecasts
 - B. documents, records and internal control manuals
 - C. decisions prepared by management
 - D. the entity's plans and office expenses

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- A. the entity's forecasts
 - B. documents, records and internal control assessments
 - C. reports prepared by management
 - D. the entity's plans and office expenses
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- A. the entity's forecasts
 - B. documents, records and internal control assessments
 - C. decisions prepared by management
 - D. the entity's plant and office facilities
80. How does the auditor use the information from the risk assessment procedures?
- A. the auditor assembles an audit team with appropriate audit skills
 - B. the auditor insures that appropriate documentation will be gathered during the audit
 - C. the auditor should determine the audit opinion based on the risk assessment
 - D. the auditor must design audit procedures to reduce the risk to an acceptably low level
81. How does the auditor use the information from the risk assessment procedures?
- A. the auditor assembles an audit team with appropriate audit skills
 - B. the auditor insures that appropriate documentation will be gathered during the audit
 - C. the auditor must determine the risk of material misstatement during an audit
 - D. the auditor should design audit procedures to reduce the risk to an acceptably low level
82. Which of the following statements best describe a misstatement?
- A. a misstatement is either an error (an unintentional mistake) or fraud (an intentional mistake) in the audit report
 - B. some misstatements are material and some are too small to be material
 - C. when a statement is material, an outsider would change his decision regarding the audit if he knew about the misstatement
 - D. some misstatements are neither material nor immaterial
83. Which of the following statements best describes a misstatement?
- A. a misstatement is either an error (an unintentional mistake) or fraud (an intentional mistake) in the financial statements
 - B. some management misstatements are material and some management misstatements are too small to be material
 - C. when a statement is material, an outsider would change his decision regarding the audit if he knew about the misstatement
 - D. some misstatements are neither material nor immaterial
84. Which of the following statements best describes a misstatement?
- A. a misstatement is either an error (an unintentional mistake) or fraud (an intentional mistake) in the audit report
 - B. some management misstatements are material and some management misstatements are too small to be material
 - C. when a statement is material, an outsider would change his decision regarding the company if he knew about the misstatement
 - D. some misstatements are neither material nor immaterial
85. To identify the risk of material misstatement, the auditor considers material misstatements at
- A. the financial reporting level
 - B. the relevant assertion level
 - C. the inherent risk level
 - D. the control risk level

86. To identify the risk of material misstatement, the auditor considers material misstatements at
- the financial statement level
 - the management assertion level
 - the inherent risk level
 - the control risk level
87. When a client hands the financial statements to the auditor, he makes the following assertion about the financial statements
- Existence or occurrence -for both classes of transactions and account balances
 - Completeness - for account balances
 - Valuation and allocation - for both classes of transactions and account balances
 - Cutoff - for both classes of transactions and account balances
88. When a client hands the financial statements to the auditor, he makes the following assertion about the financial statements
- Existence or occurrence -for account balances
 - Completeness - for both classes of transactions and account balances
 - Valuation and allocation - for both classes of transactions and account balances
 - Cutoff - for both classes of transactions and account balances
89. When a client hands the financial statements to the auditor, he makes the following assertion about the financial statements
- Existence or occurrence -for classes of transactions
 - Completeness - for account balances
 - Valuation and allocation - for account balances
 - Cutoff - for both classes of transactions and account balances
90. When a client hands the financial statements to the auditor, he makes the following assertion about the financial statements
- Existence or occurrence -for account balances
 - Completeness - for classes of transactions
 - Valuation and allocation - for classes of transactions and account balances
 - Cutoff - for classes of transactions
91. What are relevant assertions?
- Arelevant assertions are the assertions related to the income statement or balance sheet account that must . be correct if the auditor says the financial statements are materially correct
- Brelevant assertions are the assertions related to the income statement or balance sheet account that . should be correct if the auditor says the financial statements are not materially misstated
- Crelevant assertions are the assertions related to the balance sheet account that must be correct if the . auditor says the financial statements are materially correct
- Drelevant assertions are the assertions related to the income statement account that should be correct if . the auditor says the financial statements are materially correct
- E. A and B
92. What are relevant assertions?
- Arelevant assertions are the assertions related to the income statement or balance sheet account that must . be correct if the auditor says the financial statements are correct
- Brelevant assertions are the assertions related to the income statement or balance sheet account that must . be correct if the auditor says the financial statements are materially correct
- Crelevant assertions are the assertions related to the income statement or balance sheet account that might . be correct if the auditor says the financial statements are materially correct
- Drelevant assertions are the assertions related to the income statement or balance sheet account that . should be correct if the auditor says the financial statements are correct

93. Which of the following statements does not describe the way a company might use vendor allowances?
- A A supplier gives a company a vendor allowance for something they will buy in the future, allowing the company to meet their target revenue for the quarter
 - B Vendor allowances are recorded as revenue at the end of the quarter, even though the inventory purchase will not be made until the following quarter, allowing the company to meet revenue targets for the quarter
 - C When companies need to make quarterly revenue targets set by management or Wall Street analysts, they ask a supplier to give them a vendor allowance
 - D Vendor allowances allow an exchange of assets at a predetermined date so as to minimize distortion of the financial statements
94. The auditor has to develop an audit plan that responds to the risks of material misstatement identified in the prior steps of the audit process. The auditing standards require the auditor to develop an audit plan that includes which of the following elements?
- A the nature, timing, and extent of planned risk assessment procedures to allow the auditor to identify the risk of material misstatement at the financial statement and assertion level
 - B the nature, timing, and extent of audit procedures to establish the assessed risks of material misstatement at the relevant assertion level
 - C the nature, timing, and extent of audit procedures to test the effectiveness of internal controls
 - D other audit procedures that need to be done to allow the auditor to comply with generally accepted accounting principles
95. The auditor has to develop an audit plan that responds to the risks of material misstatement identified in the prior steps of the audit process. The auditing standards require the auditor to develop an audit plan that includes which of the following elements?
- A the nature, timing, and extent of planned risk assessment procedures to allow the auditor to estimate the risk of material misstatement at the financial statement and assertion level
 - B the nature, timing, and extent of audit procedures to respond to the assessed risks of material misstatement at the relevant assertion level
 - C the nature, timing, and extent of audit procedures to test the effectiveness of internal controls
 - D other audit procedures that need to be done to allow the auditor to comply with generally accepted accounting principles
96. The auditor has to develop an audit plan that responds to the risks of material misstatement identified in the prior steps of the audit process. The auditing standards require the auditor to develop an audit plan that includes which of the following elements?
- A the nature, timing, and extent of planned risk assessment procedures to allow the auditor to estimate the risk of material misstatement at the financial statement and assertion level
 - B the nature, timing, and extent of audit procedures to establish the assessed risks of material misstatement at the relevant assertion level
 - C the nature, timing, and extent of audit procedures to test the effectiveness of internal controls
 - D other audit procedures that need to be done to allow the auditor to comply with generally accepted auditing standards
97. During the planning process, the auditor determines the overall audit strategy for the audit. This strategy establishes
- A the extent of substantive tests of transactions
 - B the extent of tests of details of balances
 - C the extent of tests of controls
 - D the scope, timing and direction of the audit
98. One of the considerations in establishing an audit strategy is?
- A characteristics of the audit engagement
 - B reporting objectives, timing of testing, and nature of the client
 - C significant factors, post engagement activities, and knowledge gained on other engagements
 - D nature, timing, and extent of testing

99. One of the considerations in establishing an audit strategy is?
- A. significance of the audit engagement
 - B. reporting objectives, timing of the audit, and nature of communications
 - C. significant factors, post engagement activities, and knowledge gained on other engagements
 - D. nature, timing, and extent of testing
100. One of the considerations in establishing an audit strategy is?
- A. significance of the audit engagement
 - B. reporting objectives, timing of the audit, and nature of the client
 - C. significant factors, preliminary engagement activities, and knowledge gained on other engagements
 - D. nature, timing, and extent of testing
101. One of the considerations in establishing an audit strategy is?
- A. significance of the audit engagement
 - B. reporting objectives, timing of the audit, and nature of the client
 - C. significant factors, post engagement activities, and knowledge gained on other engagements
 - D. nature, timing, and extent of resources
102. The auditor should document the audit strategy in the form of a memorandum containing the key decisions about the scope, timing, and conduct of the audit. This documentation
- A. includes a list of the key decisions necessary to plan the audit
 - B. is a recommended part of the work papers
 - C. communicates the planning process to the client
 - D. provides the basis for the audit report to address the important issues identified in the audit strategy
103. The auditor should document the audit strategy in the form of a memorandum containing the key decisions about the scope, timing, and conduct of the audit. This documentation
- A. includes a list of the key decisions necessary to perform testing
 - B. is a required part of the work papers
 - C. communicates the planning process to the client
 - D. provides the basis for the audit report to address the important issues identified in the audit strategy
104. The auditor should document the audit strategy in the form of a memorandum containing the key decisions about the scope, timing, and conduct of the audit. This documentation
- A. includes a list of the key decisions necessary to perform testing
 - B. is a recommended part of the work papers
 - C. communicates the planning process to engagement team members
 - D. provides the basis for the audit report to address the important issues identified in the audit strategy
105. The auditor should document the audit strategy in the form of a memorandum containing the key decisions about the scope, timing, and conduct of the audit. This documentation
- A. includes a list of the key decisions necessary to perform testing
 - B. is a recommended part of the work papers
 - C. communicates the planning process to the client
 - D. provides the basis for the audit plan to address the important issues identified in the audit strategy
106. The specific procedures listed on the audit plan depend on
- A. the outcome of the risk assessment procedures
 - B. the amount of substantive testing of transactions that is required
 - C. the results of the tests of controls
 - D. the determined level of materiality

107. The documentation of the audit plan is a record of
- A. the nature, timing, and extent of risk assessment procedures and additional audit procedures at the relevant assertion level in response to the auditor's professional judgment
 - B. the nature, timing, and extent of risk assessment procedures and additional audit procedures at the relevant assertion level in response to assessed risks
 - C. the nature, timing, and extent of procedures to determine materiality and additional audit procedures at the relevant assertion level in response to assessed risks
 - D. the nature, timing, and extent of risk assessment procedures and additional audit procedures based on the client's assertions in response to assessed risks
108. The audit program describes the evidence to be gathered during the audit process. Audit program documentation demonstrates to an outside reviewer
- A. that the audit was planned
 - B. that the program is consistent with the risks of material misstatement identified during the testing stage of the audit
 - C. the audit was performed with due care
 - D. that the auditors used appropriate professional judgment
109. The audit program describes the evidence to be gathered during the audit process. Audit program documentation demonstrates to an outside reviewer
- A. that the audit procedures were approved
 - B. that the program is consistent with the risks of material misstatement identified during the planning stage of the audit
 - C. the audit was performed with due care
 - D. that the auditors used appropriate professional judgment
110. The auditing standards define audit risk as the risk that
- A. the auditor issues a qualified opinion when the financial statements are not materially misstated
 - B. the auditor issues an unqualified opinion when the financial statements are misstated
 - C. the auditor issues a qualified opinion when the financial statements are materially misstated
 - D. the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated
111. The risk of material misstatement is a function of
- A. audit risk and detection risk
 - B. inherent risk and control risk
 - C. audit risk and inherent risk
 - D. control risk and detection risk
112. The only risk controlled by the auditor is
- A. inherent risk
 - B. control risk
 - C. detection risk
 - D. the risk of material misstatement
113. Which of the following statements is correct?
- A. the auditor controls detection risk by the amount of substantive testing he or she does
 - B. the auditor controls inherent risk by the amount of control testing he or she does
 - C. the auditor controls control risk by the amount of control testing he or she does
 - D. the auditor controls audit risk by the amount of substantive testing he or she does
114. Control risk is
- A. the susceptibility of management assertions in an accounting business process to a material misstatement assuming no internal controls
 - B. the risk that internal controls fail to prevent or detect misstatements in the financial statements
 - C. the risk that substantive audit procedures fail to detect misstatements in the financial statements
 - D. the risk of assuming a clean opinion when the financial statements are materially incorrect

115. Inherent risk is

- A the susceptibility of management assertions in an accounting business process to a material misstatement assuming no internal controls
- B. the risk that internal controls fail to prevent or detect misstatements in the financial statements
- C. the risk that substantive audit procedures fail to detect misstatements in the financial statements
- D. the risk of assuming a clean opinion when the financial statements are materially incorrect

116. Detection risk is

- A the susceptibility of management assertions in an accounting business process to a material misstatement assuming no internal controls
- B. the risk that internal controls fail to prevent or detect misstatements in the financial statements
- C. the risk that substantive audit procedures fail to detect misstatements in the financial statements
- D. the risk of assuming a clean opinion when the financial statements are materially incorrect

117. The audit risk model is a theoretical model designed to guide the decision process of the auditor. The model could be used as an equation to calculate detection risk, but it is probably more useful to think of the model as expressing relationships among the risks included in the model. Some of these relationships include

- A A higher risk of material misstatement will result in a lower detection risk. A lower detection risk means that the auditor will gather more substantive evidence
- B Substantive testing is usually done because the risk of material misstatement will usually be greater than zero. Detection risk determines how much substantive testing will be done.
- C. A higher detection risk means more substantive testing is done
- D. In the model, audit risk is a varying number. It is the level of audit risk that should remain at the end of the audit.

118. The audit risk model is a theoretical model designed to guide the decision process of the auditor. The model could be used as an equation to calculate detection risk, but it is probably more useful to think of the model as expressing relationships among the risks included in the model. Some of these relationships include

- A A higher risk of material misstatement will result in a lower detection risk. A lower detection risk means that the auditor will gather less substantive evidence.
- B Substantive testing is always done because the risk of material misstatement will never be zero. Detection risk determines how much substantive testing will be done.
- C. A higher detection risk means more substantive testing is done.
- D. In the model, audit risk is a varying number. It is the level of audit risk that should remain at the end of the audit.

119. The audit risk model is a theoretical model designed to guide the decision process of the auditor. The model could be used as an equation to calculate detection risk, but it is probably more useful to think of the model as expressing relationships among the risks included in the model. Some of these relationships include

- A A higher risk of material misstatement will result in a lower detection risk. A lower detection risk means that the auditor will gather less substantive evidence.
- B Substantive testing is usually done because the risk of material misstatement will usually be zero. Detection risk determines how much substantive testing will be done.
- C. A higher detection risk means less substantive testing is done.
- D. In the model, audit risk is a varying number. It is the level of audit risk that should remain at the end of the audit.

120. The audit risk model is a theoretical model designed to guide the decision process of the auditor. The model could be used as an equation to calculate detection risk, but it is probably more useful to think of the model as expressing relationships among the risks included in the model. Some of these relationships include
- A. A higher risk of material misstatement will result in a lower detection risk. A lower detection risk means that the auditor will gather less substantive evidence.
 - B. Substantive testing is usually done because the risk of material misstatement will usually be zero. Detection risk determines how much substantive testing will be done.
 - C. A higher detection risk means more substantive testing is done.
 - D. In the model, audit risk is a constant number. It is the level of audit risk that should remain at the end of the audit.
121. The audit risk model is a theoretical model designed to guide the decision process of the auditor. The model could be used as an equation to calculate detection risk, but it is probably more useful to think of the model as expressing relationships among the risks included in the model. Some of these relationships include
- A. A lower risk of material misstatement will result in a higher detection risk. A higher detection risk means that the auditor will gather less substantive evidence.
 - B. Substantive testing is usually done because the risk of material misstatement will usually be zero. Detection risk determines how much substantive testing will be done.
 - C. A lower detection risk means less substantive testing is done.
 - D. In the model, audit risk is a varying number. It is the level of audit risk that should remain at the end of the audit.
122. The audit risk model is a theoretical model designed to guide the decision process of the auditor. The model could be used as an equation to calculate detection risk, but it is probably more useful to think of the model as expressing relationships among the risks included in the model. Some of these relationships include
- A. A lower risk of material misstatement will result in a lower detection risk. A lower detection risk means that the auditor will gather more substantive evidence.
 - B. Substantive testing is usually done because the risk of material misstatement will usually be zero. Detection risk determines how much substantive testing will be done.
 - C. A lower detection risk means more substantive testing is done.
 - D. In the model, audit risk is a varying number. It is the level of audit risk that should remain at the end of the audit.
123. The system of quality control established by an accounting firm should address which of the following?
- A. leadership responsibilities for quality within the firm
 - B. business administrative requirements
 - C. acceptance and continuance of audit relationships
 - D. human resources payroll processing
124. The system of quality control established by an accounting firm should address which of the following?
- A. audits are performed in the same manner for all clients
 - B. relevant ethical requirements
 - C. acceptance and continuance of audit relationships
 - D. human resources payroll processing
125. The system of quality control established by an accounting firm should address which of the following?
- A. audits are performed in the same manner for all clients
 - B. business administrative requirements
 - C. acceptance and continuance of client relationships and specific engagements
 - D. human resources payroll processing

126. The system of quality control established by an accounting firm should address which of the following?
- A. audits are performed in the same manner for all clients
 - B. business administrative requirements
 - C. acceptance and continuance of audit relationships
 - D. human resources
127. The audit risk model is a theoretical model designed to guide the decision process of the auditor. The model could be used as an equation to calculate detection risk, but it is probably more useful to think of the model as expressing relationships among the risks included in the model. Some of these relationships include
- AA lower control risk will mean that more internal control testing is done. If more internal control testing is done the auditor will gather less substantive evidence.
 - BA higher control risk will mean that more internal control testing is done. If more internal control testing is done the auditor will gather more substantive evidence.
 - C Substantive testing is usually done regardless of the level of control risk because the risk of material misstatement will usually be zero.
 - D. A higher detection risk means more substantive testing is done.
 - E. In the model, audit risk is a varying number. It is the level of audit risk that should remain at the end of the audit.
128. The audit risk model is a theoretical model designed to guide the decision process of the auditor. The model could be used as an equation to calculate detection risk, but it is probably more useful to think of the model as expressing relationships among the risks included in the model. Some of these relationships include
- AA lower control risk will mean that more internal control testing is done. If more internal control testing is done the auditor will also gather more substantive evidence.
 - BA higher control risk will mean that less internal control testing is done. If less internal control testing is done the auditor will gather more substantive evidence.
 - C Substantive testing is usually done regardless of the level of control risk because the risk of material misstatement will usually be zero.
 - D. A higher detection risk means more substantive testing is done.
 - E. In the model, audit risk is a varying number. It is the level of audit risk that should remain at the end of the audit.
129. The audit risk model is a theoretical model designed to guide the decision process of the auditor. The model could be used as an equation to calculate detection risk, but it is probably more useful to think of the model as expressing relationships among the risks included in the model. Some of these relationships include
- AA higher risk of material misstatement will result in a lower detection risk. A lower detection risk means that the auditor will gather less substantive evidence.
 - B Substantive testing is usually done because the risk of material misstatement will usually be zero.
 - . Detection risk determines how much substantive testing will be done.
 - C. A lower detection risk means that more control testing has been done.
 - D. A lower detection risk will result in that more substantive testing is done.

130. During an audit engagement, the auditing standards require the auditor to *assess the risk of material misstatement from errors or fraud*.

- a. Explain what is meant by the concept of the risk of material misstatement due to errors or fraud.
- b. Explain how the auditor performs this risk assessment and uses the information gained from the assessment to (1) *plan* the audit and (2) to perform the audit.
- c. How does the auditor use the audit risk model to reduce audit risk to an acceptably low level at the financial statement level *and* the assertion level?
- d. Evaluate the following statement: "Risk assessment is an element of the audit, but absolutely not the most important element".

131. Assume that you have been assigned to the audit of an international bank. The bank does business in 20 countries, including the United States, Germany, and Norway.

- a. Discuss the *demand for auditing*. Why would an audit be useful for parties outside the bank?
- b. Define the *risk of material misstatement* for this bank. Describe how you as an auditor would go about assessing and controlling this risk.
- c. Define *audit risk* as it relates to this client. Identify the financial statement accounts that provide the highest audit risk for the auditor and explain how you would control this risk.

132. Assume you were working on the year-end audit of a public university.

- a. Identify the significant accounts and the relevant assertions for these accounts at your school. Explain your answer.
- b. How would analytical procedures be used to gather audit evidence for the audit?

133. On the basis of audit evidence gathered, an auditor decides to increase the assessed level of control risk from that originally planned. To achieve an overall audit risk level that is substantially the same as the planned audit risk level, the auditor would need to adjust detection risk.
- Explain the audit evidence gathered that led the auditor to the conclusion that control risk must be increased and why the auditor evaluated the evidence in the manner described in the problem.
 - Consider the impact of changing the risk of material misstatement on the calculation of detection risk. First assume that IR and CR are 1.0. Then assume that IR and CR are .30. Using the audit risk model, explain the affect on DR of each level specified for IR and CR. How much internal control testing does the auditor do with each assessment of the risk of material misstatement? How does the auditor determine each risk?
134. Assume that you are using the audit risk model to plan your testwork for an audit.
- If inherent risk was assessed at .50 and internal control risk was assessed at .30, what is detection risk?
 - What evidence should the auditor gather to support the inherent risk and control risk assessment?
 - If the auditor determines that control risk is .50 instead of .30, what impact will this have on detection risk? Calculate the new detection risk.
 - When CR is .50 instead of .30 will the auditor perform more or less substantive testwork? Explain your answer.
 - When CR is .50 instead of .30, will the auditor perform more or less internal control testwork? Explain your answer.
 - If the auditor decreases control risk from .70 to .50, will they do more or less internal control testing? More or less substantive testing? Explain your answer.
 - What is audit risk? Does audit risk differ from one client to another client? Explain your answer.
 - Does audit risk differ from one auditing firm to another? Explain your answer.

ch02 Key

1. TRUE
2. FALSE
3. FALSE
4. TRUE
5. TRUE
6. FALSE
7. FALSE
8. TRUE
9. FALSE
10. FALSE
11. TRUE
12. FALSE
13. B
14. A
15. C
16. D
17. A
18. B
19. D
20. A
21. B
22. C
23. A
24. C
25. A
26. B
27. D
28. A
29. C
30. D
31. E
32. A
33. B
34. C
35. D
36. C

37. A
38. C
39. D
40. A
41. B
42. C
43. D
44. B
45. C
46. B
47. C
48. D
49. B
50. C
51. E
52. E
53. B
54. D
55. E
56. B
57. C
58. D
59. B
60. E
61. C
62. A
63. C
64. B
65. C
66. A
67. B
68. C
69. D
70. A
71. B
72. C
73. D
74. A

75. B
76. A
77. B
78. C
79. D
80. D
81. C
82. B
83. A
84. C
85. B
86. A
87. A
88. B
89. C
90. D
91. E
92. B
93. D
94. A
95. B
96. D
97. D
98. A
99. B
100. C
101. D
102. A
103. B
104. C
105. D
106. A
107. B
108. A
109. B
110. D
111. B
112. C

- 113. A
- 114. B
- 115. A
- 116. C
- 117. A
- 118. B
- 119. C
- 120. D
- 121. A
- 122. C
- 123. A
- 124. B
- 125. C
- 126. D
- 127. A
- 128. B
- 129. D

d. This statement is false. Risk assessment is one of the most important elements of the audit. Risk assessment done at the beginning of the audit determines the audit plan used to gather evidence. If risks are not correctly identified, the auditor will spend his time during the audit gathering evidence related to financial statement accounts or assertions that have a lower risk of material misstatement. This would be both an inefficient way to conduct an audit and an ineffective way to conduct an audit. In this case, the auditor has a much higher chance of issuing an incorrect opinion (saying the financial statements are not materially misstated when they are), so this fact makes risk assessment a very important element of the audit.

c. The auditor uses the audit risk to model to *determine the amount of substantive testing needed* to keep audit risk to an acceptably low level. The calculation of DR allows the auditor to determine the amount of substantive testing needed. DR is calculated at both the financial statement level and the individual assertion level for assertions identified as relevant to significant (or material) accounts in the audit.

The auditor uses the information gained from the risk assessment to plan the audit and to perform the audit. He does this by identifying financial statement accounts or assertions for accounts where the risk of material misstatement is present and then *designs* and *performs* audit procedures to determine if the area identified is materially misstated. So the risk assessment identifies audit areas where the auditor should gather sufficient appropriate evidence to determine that the financial statements are not materially misstated. The audit program is written based on the risk of material misstatement and the audit work is performed so the auditor gathers sufficient appropriate evidence to control this risk.

- The auditing standards require the audit team to have a discussion involving all audit members about the risk of material misstatement due to fraud. Auditors should presume a risk of material misstatement due to fraud for the revenue process.

(3)

- The auditor becomes familiar with current economic environment by reading financial newspapers and other financial periodicals.

- The auditor gains knowledge of the client and the industry by talking to the client and reading any material on the client or the industry that may help the auditor understand the business.

(2)

- The auditor will also calculate financial ratios for the current and prior year and will identify changes in the ratios that appear unreasonable.

- The auditor will compare the financial statements for the current year and the prior year and will identify changes in the accounts that appear to be unreasonable. An unreasonable change may be based on the amount of the change or the percentage of the change.

(1)

b. The auditor must assess the risk of material misstatement due to both errors and fraud. The auditor assesses the risk of material misstatement by (1) performing analytical procedures, (2) gaining knowledge of the environment where the client operates (the industry and current economic conditions), and (3) considering the risk of fraud in the financial statements as a whole and for relevant assertions for significant accounts in the financial statements.

130. a. The risk of material misstatement due to errors or fraud is the risk that the financial statements contain misstatements that are material (misstatements that would cause outsiders to change their decisions about the company) that are caused by company errors (unintentional actions) or by fraud (intentional actions).

- For this bank, audit risk is the risk that the auditor issues a clean opinion when the financial statements are materially misstated because it contains loans receivable that it will not collect. Revenue related to the loans has been recognized by the bank in anticipation of collecting the loans. Therefore assets are overstated and revenue is overstated (or expense is understated). The future cash flow of the company is not accurately represented by the amount of receivables on the books.
- The biggest risk for the auditor in the current banking environment is the risk that the client has uncollectible loans on its balance sheet. The probability that the auditor will find bad loans on the books is quite high given the current banking situation and the fact that our audit client is an international bank with loans in the US, Germany, and Europe. The accounts most likely to be misstated are Receivables for Bank Loans (an asset account) and the Reserve for Uncollectible Accounts (an expense account.)
- Audit risk is the risk that the auditor issues an unqualified (clean) opinion when the financial statements are materially misstated.

c.

The risk of material misstatement is *the risk that the financial statements contain misstatements (from errors or fraud) and that internal controls fail to prevent or detect them*. To assess this risk the auditor will determine control risk and inherent risk for the financial statements as a whole and for relevant assertions for significant accounts. The auditor uses this information to calculate detection risk. The auditor gathers substantive evidence consistent with the detection risk calculated to keep audit risk to an acceptably low level (usually 5 %.)

b.

- Auditors are *independent*, which means that they have no reason to misstate the financial information provided in the annual report. The information they provide is prepared according to a set of standards (*generally accepted accounting principles in the U.S. or IFRS internationally*). During an audit, the auditor follows a set of standards to gather and evaluate evidence (*generally accepted auditing standards*). This consistency in the presentation and analysis of information allows outsiders to compare financial statements from one company to another knowing that the same general principles were used to prepare and audit company information.
- Outsiders determine that an audit is useful to them because they cannot rely on the managers to give them accurate information and they have no other way to get accurate information. The managers are not independent from the firm and are likely to provide outsiders with information that makes the company appear better than it really is. In effect, the *outsiders cannot trust management* to provide them with accurate information about the company because management has little incentive to provide outsiders with information that may indicate that company performance is not as good as desired.
- The *demand for auditing* is based on the separation of ownership between the people who own the bank and the people who manage the bank. This is often referred to as the *principal-agent* problem. The agent (management) has more information than the principal (the owner). In this setting, the auditor makes sure that the principal gets the information he needs to make decisions about the company.

131. a.

b. Analytical procedures might be used to audit tuition revenue. The auditor can estimate the amount of tuition revenue by taking the full-time equivalent number of students times the tuition costs (adjusting for out-of-state tuition rates or graduate school tuition rates as needed). This estimate should allow the auditor to determine whether the revenue recognized by the university is reasonable. The auditor can also audit the payroll expense in a similar fashion. Number of employees at each rank times average salary at each rank (a similar calculation for support staff is needed).

132. a. On the income statement, tuition revenue and grant revenue may be significant accounts for a university. Payroll expense is also likely to be a significant account because it is the largest expense on the income statement. The balance sheet may not have any significant accounts—few accounts receivable (students pay their fees or leave), little inventory (bookstore items usually), fixed assets are material assets, but have little risk associated with them, accounts payable (states provide the funds to pay these bills), and no long-term debt. The relevant assertion for tuition and grant revenue is existence. The relevant assertion for payroll expense is completeness. There may also be a relevant assertion related to grant revenue if the funds are for purposes that are restricted. If the university has restricted funds, the auditor must determine that the university has complied with the requirements of the fund.

Detection risk is a calculated risk, based on AR, IR, and CR. DR is adjusted to the level needed to keep audit risk to an acceptably low level. *Audit risk* is determined based on professional judgment. It is defined in the standards as an acceptably low level (or an appropriately low level) of saying that the financial statements are not materially misstated when they are. Control risk is assessed at a minimum level (.3) if internal controls exist and the auditor believes that they will prevent or detect misstatements. *Inherent risk* is assessed based on the professional judgment of the auditor. *Control risk* is assessed at maximum by the auditor because controls either do not exist or do not work to prevent or detect misstatements. The auditor performs more internal control testing when the risk of material misstatement = .30, than when the risk of material misstatement = 1.0. b. When the risk of material misstatement = 1.0, $DR = .05 (.05/(1 \times 1))$. When the risk of material misstatement = .30, $DR = .5555 (.05/((.3 \times .3)))$. The auditor performs more substantive testing when the risk of material misstatement = 1, than when the risk of material misstatement = .30. (DR = .05 or DR = .555).

133. a. Based on internal control tests, the auditor determined that controls were not working at the expected level to prevent or detect misstatements (the auditor found more deviations than expected during the internal control test). If control risk increases because controls are not working at the level expected, the auditor must decrease detection risk, increasing substantive testwork.

h. No, it probably does not differ from one firm to the next in the same category of firms (big 4, mid-tier, small). If it differed, the amount of testing would differ, and the audit fee would differ. The firm doing the least amount of testing would win all the bids for audit engagements.

g. Audit risk is the risk of issuing an audit opinion stating that the financial statements are not materially misstated when they are. It is thought to be about 5%. 5% of the time the wrong opinion is issued, 95% of the time the correct opinion is issued. It probably does not differ much from 1 client to the next.

f. The auditor will perform more internal control testing and less substantive testing. The auditor gets more evidence from internal control testing. $DR = .14 (CR = .70)$ versus $DR = .20 (CR = .50)$.

e. The auditor will perform less internal control testing. Less testing required if controls work 50% of the time, than if they work 70% ($1.0 - CR$) of the time.

d. The auditor will perform more substantive testwork. CR is greater, so controls cannot be relied upon to the same extent to detect or prevent misstatements. Auditor will need to increase the substantive testing to keep audit risk to an acceptably low level (about .05).

c. $DR = .05/((.5 \times .5)) = .20$. Detection risk decreases.

b. The inherent risk decision is made based on the professional judgment of the auditor. The control risk decision is made based on the professional judgment of the auditor and must be supported by internal control testing.

134. a. $DR = .05/((.5 \times .3)) = .33333$

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