**Chapter 11 Auditing Theory**

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| Multiple-Choice Questions |
| 1. | Which of the following best defines fraud in a financial statement auditing context? |
| easy | a. Fraud is an unintentional misstatement of the financial statements. |
| b | b. Fraud is an intentional misstatement of the financial statements. |
|  | c. Fraud is either an intentional or unintentional misstatement of the financial statements, depending on materiality. |
|  | d. Fraud is either an intentional or unintentional misstatement of the financial statements, depending on consistency. |
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| 2.easy | One of the earliest frauds occurred at McKesson-Robbins. This company committed fraud by doing which of the following? |
| b | a. Reporting fictitious contributed capital. |
|  | b. Reporting fictitious sales and nonexistent inventory. |
|  | c. Reporting fictitious fixed assets and underreporting expenses. |
|  | d. Reporting expenses as capitalized items. |
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| 3. | Which of the following is a category of fraud? |
| easy |  |
| a |  | Fraudulent financial reporting |  | Misappropriation of assets |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
|  |  |
| 4. | With respect to fraudulent financial reporting, most frauds involve: |
| easy |  |
| d |  | Inventory or liquid asset theft |  | Intentional misstatements of amounts |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
|  |  |
| 5. | \_\_\_\_\_\_\_\_ is fraud that involves theft of an entity’s assets. |
| easy | a. Fraudulent financial reporting |
| c | b. A “cookie jar” reserve |
|  | c. Misappropriation of assets |
|  | d. Income smoothing |
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| 6. | \_\_\_\_\_\_\_\_ involves deliberate actions taken by management to meet earnings objectives. |
| easy | a. Expenditure management |
| b | b. Earnings management |
|  | c. Top-line management |
|  | d. Management-by-objective |
|  |  |
| 7.easy | \_\_\_\_\_\_\_\_ is a form of earnings management in which revenues and expenses are shifted between periods to reduce fluctuations in earnings. |
| c | a. Fraudulent financial reporting |
|  | b. Expense smoothing |
|  | c. Income smoothing |
|  | d. Each of the above is correct |
|  |  |
| 8. | Which of the following is one of the conditions for fraud described in SAS No. 99? |
| easy |  |  |  |  |  |  |
| a |  | Attitudes/rationalization |  | Risk Factors |  | Opportunities |
|  | a. | Yes |  | No |  | Yes |
|  | b. | No |  | Yes |  | Yes |
|  | c. | Yes |  | No |  | No |
|  | d. | No |  | Yes |  | No |
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| 9. | Fraudulent financial reporting may be accomplished through the manipulation of: |
| easy | a. assets. |
| d | b. revenues. |
|  | c. liabilities. |
|  | d. all of the above |
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| 10. | Who is most likely to perpetrate fraudulent financial reporting? |
| easy | a. Members of the board of directors |
| c | b. Production employees |
|  | c. Management of the company |
|  | d. The internal auditors |
|  |  |
| 11. | Misappropriation of assets is normally perpetrated by: |
| easy | a. members of the board of directors. |
| b | b. employees at lower levels of the organization. |
|  | c. management of the company. |
|  | d. the internal auditors. |
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| 12.medium | Which of the following is not a factor that relates to opportunities to commit fraudulent financial reporting? |
| c | a. Lack of controls related to the calculation and approval of accounting estimates. |
|  | b. Ineffective oversight of financial reporting by the board of directors. |
|  | c. Management’s practice of making overly aggressive forecasts. |
|  | d. High turnover of accounting, internal audit, and information technology staff. |
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| 13. | The most common technique used by management to misstate financial information is: |
| medium | a. overstatement of expenses. |
| b | b. improper revenue recognition. |
|  | c. understatement of liabilities. |
|  | d. understatement of assets. |
|  |  |
| 14.medium | Which of the following is a factor that relates to incentives or pressures to commit fraudulent financial reporting? |
| b | a. Significant accounting estimates involving subjective judgments. |
|  | b. Excessive pressure for management to meet debt repayment requirements. |
|  | c. Management’s practice of making overly aggressive forecasts. |
|  | d. High turnover of accounting, internal audit, and information technology staff. |
|  |  |
| 15.medium | Which of the following is a factor that relates to attitudes or rationalization to commit fraudulent financial reporting? |
| c | a. Significant accounting estimates involving subjective judgments. |
|  | b. Excessive pressure for management to meet debt repayment requirements. |
|  | c. Management’s practice of making overly aggressive forecasts. |
|  | d. High turnover of accounting, internal audit and information technology staff. |
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| 16.medium | Which of the following statements describes circumstances that underlie employee incentives to misappropriate assets? |
| a | a. Dissatisfied employees may steal from a sense of entitlement. |
|  | b. Weak internal controls encourage employees to take chances. |
|  | c. If management cheats customers and gets away with it, then employees believe they can do the same to the company. |
|  | d. Employees have a vested interest in making the company’s financial statements erroneous. |
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| 17. | Which of the following is not a factor that relates to opportunities to misappropriate assets? |
| medium | a. Inadequate internal controls over assets. |
| d | b. Presence of large amounts of cash on hand. |
|  | c. Inappropriate segregation of duties or independent checks on performance. |
|  | d. Adverse relationships between management and employees. |
|  |  |
| 18. | Which of the following is a factor that relates to incentives to misappropriate assets? |
| medium | a. Significant accounting estimates involving subjective judgments. |
| b | b. Significant personal financial obligations. |
|  | c. Management’s practice of making overly aggressive forecasts. |
|  | d. High turnover of accounting, internal audit and information technology staff. |
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| 19.medium | Which of the following issues is normally part of the “brainstorming” session required by SAS No. 99? |
| a |  |
|  |  | How assets could be misappropriated |  | Where the entity’s financial statements are susceptible to material misstatements due to fraud |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
|  |  |
| 20. | In the fraud triangle, fraudulent financial reporting and misappropriation of assets: |
| medium | a. share little in common. |
| c | b. share most of the same risk factors. |
|  | c. share the same three conditions.  |
|  | d. share most of the same conditions. |
|  |  |
| 21. | Sources of information gathered to assess fraud risks usually do not include: |
| medium | a. analytical procedures. |
| d | b. inquiries of management. |
|  | c. communication among audit team members. |
|  | d. review of corporate charter and bylaws. |
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| 22.medium | SAS No. 99 requires auditors to document which of the following matters related to the auditor’s consideration of material misstatements due to fraud? |
| b | a. Reasons supporting a conclusion that there is not a significant risk of material improper expense recognition. |
|  | b. Procedures performed to obtain information necessary to identify and assess the risks of material fraud. |
|  | c. Results of the internal auditor’s procedures performed to address the risk of management override of controls. |
|  | d. Discussions with management regarding separation of duties. |
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| 23. | Under SAS No. 99, auditors are to presume that there is a significant risk of: |
| medium | a. overstated assets. |
| c | b. understated liabilities. |
|  | c. improper revenue recognition. |
|  | d. overstated expenses. |
|  |  |
| 24.medium | After fraud risks are identified and documented, the auditor should evaluate factors that \_\_\_\_\_\_ fraud risk before developing an appropriate response to the risk of fraud. |
| b | a. enhance |
|  | b. reduce |
|  | c. increase |
|  | d. increase or decrease |
|  |  |
| 25.medium | Which of the following parties is responsible for implementing internal controls to minimize the likelihood of fraud? |
| c | a. External auditors |
|  | b. Audit committee members |
|  | c. Management |
|  | d. Committee of Sponsoring Organizations |
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| 26. | The most effective way to prevent and deter fraud is to: |
| medium | a. implement programs and controls that are based on core values embraced by the company. |
| a | b. hire highly ethical employees. |
|  | c. communicate expectations to all employees on an annual basis. |
|  | d. terminate employees who are suspected of committing fraud. |
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| 27. | Fraud awareness training should be: |
| medium | a. broad and all-encompassing |
| c | b. extensive and include details for all functional areas |
|  | c. specifically related to the employee’s job responsibility  |
|  | d. focused on employees understanding the importance of ethics |
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| 28. | As part of the brainstorming sessions, auditors are directed to emphasize: |
| medium |  |
| a |  | The need for professional skepticism |  | The audit team’s response to potential fraud risks |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
|  |  |
| 29. | Auditor responses to fraud risks include which of the following? |
| medium |  |
| d |  | Perform procedures to result in the issuance of a qualified opinion |  | Perform procedures to address the risk of management override of controls |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
|  |  |
| 30.medium | As part of designing and performing procedures to address management override of controls, auditors must perform which of the following procedures? |
| d |  |
|  |  | Examine all journal entries above the level of materiality |  | Review accounting estimates for biases |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
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| 31.medium | Which of the following most accurately defines professional skepticism as it is used in auditing standards? |
| b | a. It either assumes management is honest or slightly dishonest, but neither all the time. |
|  | b. It neither assumes that management is dishonest nor assumes unquestioned honesty. |
|  | c. It assumes management is honest most of the time. |
|  | d. It assumes that management is dishonest in only rare instances. |
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| 32.mediuma | Auditors may identify conditions during fieldwork that change or support a judgment about the initial assessment of fraud risks. Which of the following is not a condition which should alert an auditor that the initial assessment should be changed? |
|  | a. The auditor’s lack of independence |
|  | b. Discrepancies in the accounting records |
|  | c. Unusual relationships between the auditor and management |
|  | d. Missing or conflicting evidence |
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| 33. | Which of the following is least likely to uncover fraud? |
| medium | a. External auditors |
| a | b. Internal auditors |
|  | c. Internal controls |
|  | d. Management |
|  |  |
| 34.medium | For inquiry to be effective, auditors need to be skilled at listening and \_\_\_\_\_\_\_ an interviewee’s response to questions. |
| a | a. evaluating |
|  | b. recording |
|  | c. transcribing |
|  | d. remembering |
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| 35. | Which of the following is **not** a likely source of information to assess fraud risks? |
| challenging | a. Communications among audit team members. |
| d | b. Inquiries of management. |
|  | c. Analytical procedures. |
|  | d. Consideration of fraud risks discovered during recent audits of other clients. |
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| 36. | Which of the following is not a category of inquiry used by auditors? |
| challenging | a. Assessment inquiry |
| b | b. Declarative inquiry |
|  | c. Interrogative inquiry |
|  | d. Informational inquiry |
|  |  |
| 37.challenging | \_\_\_\_\_\_\_\_\_\_\_ inquiry is used when the auditor seeks responses from the interviewee about his or her knowledge of an event or circumstance. |
| c | a. Assessment  |
|  | b. Declarative  |
|  | c. Interrogative  |
|  | d. Informational  |
|  |  |
| 38. | \_\_\_\_\_\_\_\_\_\_\_ inquiry is used to obtain details about facts that the auditor does not have. |
| challenging | a. Assessment  |
| c | b. Declarative  |
|  | c. Interrogative  |
|  | d. Informational |
|  |  |
| 39.challenging | \_\_\_\_\_\_\_\_\_\_\_ inquiry is used to ascertain whether information already obtained is correct, factual or truthful. |
| a | a. Assessment  |
|  | b. Declarative  |
|  | c. Interrogative  |
|  | d. Informational |
|  |  |
| 40. | This type of inquiry often elicits “yes” or “no” responses to the auditor’s questions. |
| challenging | a. Assessment  |
| c | b. Declarative  |
|  | c. Interrogative  |
|  | d. Informational |
|  |  |
| 41. | Which of the following non-verbal cues is a sign of stress? |
| challenging | a. Leaning away from the auditor, usually toward the door or window |
| b | b. Avoiding eye contact |
|  | c. Crossing one’s arms or legs |
|  | d. Each of the above is a sign of stress |
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| 42.challenging | Which party has the primary responsibility to oversee an organization’s financial reporting and internal control processes? |
| b | a. The board of directors |
|  | b. The audit committee |
|  | c. Management of the company |
|  | d. The financial statement auditors |
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| 43. | When the auditor suspects that fraud may be present, SAS No. 99 requires the auditor to: |
| challenging | a. terminate the engagement with sufficient notice given to the client.  |
| c | b. issue an adverse opinion or a disclaimer of opinion. |
|  | c. obtain additional evidence to determine whether material fraud has occurred. |
|  | d. re-issue the engagement letter. |
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| 44.challenging | With whom should the auditor communicate whenever he or she determines that senior management fraud may be present, even if the matter might be considered inconsequential? |
| b | a. PCAOB |
|  | b. Audit committee |
|  | c. An appropriate level of management that is at least one level above those involved |
|  | d. The internal auditors |
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| 45. | Management is responsible for: |
| medium |  |  |  |  |
| a |  | Identifying and measuring fraud risks |  | Taking steps to mitigate identified risks |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
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Essay Questions

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| 46.easy | Define fraud and distinguish between the two main categories of fraud. |
|  | Answer: In the context of financial statement auditing, fraud is defined as an intentional misstatement of the financial statements.The two main categories of fraud are fraudulent financial reporting and misappropriation of assets. Fraudulent financial reporting is an intentional misstatement or omission of amounts or disclosures with the intent to deceive users of the financial statement. Misappropriation of assets involve theft of an entity’s assets. |

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| 47.easy | List and briefly describe the three conditions for fraud arising from fraudulent financial reporting and misappropriation of assets as described in SAS No. 99. |
|  | Answer:* Incentives/pressures – Management or other employees have incentives or pressures to commit fraud.
* Opportunities – Circumstances provide opportunities for management or employees to commit fraud.
* Attitudes/Rationalization – An attitude, character, or set of ethical values exists that allows management or employees to intentionally commit a dishonest act, or they are in an environment that imposes sufficient pressure that causes them to rationalize committing a dishonest act.
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| 48.medium | Explain professional skepticism and the need for maintaining professional skepticism during an audit. |
|  | Answer:SAS No. 1 states that, in exercising professional skepticism, an auditor “neither assumes that management is dishonest nor assumes unquestioned honesty.” Auditors need to maintain their skepticism and a questioning mind throughout the audit so that they can identify fraud risk and critically evaluate audit evidence. |
| 49.medium | Briefly discuss the brainstorming session required by SAS No. 99. Be sure to include a list of ideas that should be addressed in the session. |
|  | Answer:SAS No. 99 requires the audit team to conduct discussions to share insights from more experienced audit team members and to “brainstorm” ideas that address several ideas. The ideas that should be discussed are:* How and where the entity’s financial statements might be susceptible to material misstatements due to fraud.
* How management could perpetrate and conceal fraudulent financial reporting.
* How assets of the entity could be misappropriated.
* How the auditor might respond to the susceptibility of material misstatements due to fraud.
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| 50.medium | What are the three main types of revenue manipulations employed to commit fraudulent financial reporting? |
|  | Answer:The three main types of revenue manipulation are:* Fictitious revenues,
* Premature revenue recognition, and
* Manipulation of adjustments to revenues.
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| 51. (Public)challenging | PCAOB Standard 2 requires auditors to evaluate the effectiveness of the audit committee as part of the assessment of the internal control. Briefly describe what factors auditors might consider in evaluating the effectiveness of the audit committee. |
|  | Answer:Auditors might consider:* the audit committee’s independence from the management of the company,
* the level of understanding about the audit committee’s responsibilities between management and the audit committee, and
* the level and types of interactions between the audit committee and internal auditors and external auditors.
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| 52.challenging | List and briefly describe examples of risk factors for each condition of fraud for fraudulent financial reporting. |
|  | Answer:*Incentives/Pressures*: 1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions. 2. Excessive pressure for management to meet debt repayment or other debt covenant requirements. 3. Management or the board of directors’ personal net worth is materially threatened by the entity’s financial performance.*Opportunities*: 1. Significant accounting estimates involve subjective judgments or uncertainties that are difficult to verify. 2. Ineffective board of director or audit committee oversight over financial reporting. 3. High turnover or ineffective accounting, internal audit, or information technology staff.*Attitudes/Rationalization*: 1. Inappropriate or ineffective support of the entity’s ethics and values. 2. Known history of violations of laws and regulations. 3. Management’s disregard for the financial reporting process. |
| 53.challenging | Auditors are required to perform certain procedures in every audit to address the risk of management override of internal controls. What are these procedures? |
|  | Answer:SAS No. 99 requires the following:* Examine journal entries and other adjustments for evidence of possible misstatements due to fraud.
* Review accounting estimates for bias.
* Evaluate the business rationale for significant unusual transactions.
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| 54.challenging | List and briefly describe examples of risk factors for each condition of fraud for misappropriation of assets. |
|  | Answer:*Incentives/Pressures*: 1. Personal financial obligations create pressure for those with access to cash or other assets susceptible to theft to misappropriate those assets. 2. Adverse relationships between management and employees with access to assets susceptible to theft motivate employees to misappropriate those assets. *Opportunities*: 1. Presence of large amounts of cash on hand or inventory items that are small, of high value, or in high demand. 2. Inadequate internal control over assets.*Attitudes/Rationalization*: 1. Disregard for the need to monitor misappropriations of assets. 2. Disregard for internal controls or failing to correct control deficiencies. |
| 55.challenging | Describe the sources of information gathered to assess fraud risks. |
|  | Answer:When the auditor is assessing fraud risks the following information sources should be considered:* Information obtained from communications among audit team members about their knowledge of the company and its industry, including how and where the company’s financial statements might be susceptible to material misstatements due to fraud.
* Responses to auditor inquiries of management about their views of the risks of fraud and about existing programs and controls to address specific identified fraud risks.
* Specific risk factors in fraudulent financial reporting or misappropriation of assets.
* Analytical procedures results obtained during planning that indicate possible implausible or unexpected analytical relationships.
* Knowledge obtained through other procedures such as client acceptance and retention decisions, interim review of financial statements, and consideration of inherent and control risks.
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| 56.challenging | What matters related to their consideration of fraud must auditors document according to SAS No. 99? |
|  | Answer:* The discussion among engagement team personnel in planning the audit about the susceptibility of the entity’s financial statements to material fraud.
* Procedures performed to obtain information necessary to identify and assess the risks of material fraud.
* Specific risks of material fraud that were identified, and a description of the auditor’s response to those risks.
* Reasons supporting a conclusion that there is not a significant risk of material improper revenue recognition.
* Results of the procedures performed to address the risk of management override of controls.
* Other conditions and analytical relationships that indicated that additional auditing procedures or other responses were required, and the actions taken by the auditor.
* The nature of communications about fraud made to management, the audit committee, or others.
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| 57.challenging | Management and the board of directors are responsible for setting the “tone at the top.” What is meant by “tone at the top?” |
|  | Answer:Management cannot act one way and expect others in the company to behave differently. Through its actions and communications, management can show that dishonest or unethical behavior is not tolerated, even if the results benefit the company. Statements by management about the absolute need to meet operating and financial targets create undue pressures that may lead employees to commit fraud to achieve them. In contrast, statements indicating management’s desire to aggressively pursue entity’s goals and targets while at the same time requiring honest and ethical actions to achieve those goals clearly indicates to employees that integrity is a requirement. Whichever course management pursues, its actions establish the “tone at the top.” |
| 58.challenging | What types of inquiry techniques might an auditor use when making inquiries of client personnel? What are the uses of each technique? |
|  | Answer:There are three main types of inquiry available for use by auditors. These are information inquiry, assessment inquiry, and interrogative inquiry. Information inquiry is used to obtain information about facts and details that the auditor does not have. Assessment inquiry is used to corroborate or contradict prior information. Interrogative inquiry is often used when the auditor seeks responses from an individual about his or her knowledge of an event or circumstances. |

Other Objective Answer Format Questions

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| 59.easya | In the context of financial statement auditing, fraud is defined as an intentional misstatement of the financial statements.a. Trueb. False |
| 60.easya | The two main categories of fraud are fraudulent financial reporting and misappropriation of assets.a. Trueb. False |
| 61.easyb | “Cookie jar reserves” are often created by companies whenever their earnings are high to create reserves for future periods when earnings are at or above current levels.a. Trueb. False |
| 62.easya | Management and the board of directors are responsible for setting the “tone at the top.”a. Trueb. False |
| 63.easyb | Two conditions are generally present when material misstatements due to fraud occur – incentives and opportunities.a. Trueb. False |
| 64.easya | Financial statements of all companies are potentially subject to manipulation.a. Trueb. False |
| 65.easyb | Fraud is more prevalent in large businesses than small businesses and not-for-profit organizations.a. Trueb. False |
| 66.mediuma | The audit committee is responsible for overseeing an organization’s financial reporting and internal control processes.a. Trueb. False |
| 67.mediuma | The same three fraud triangle risk conditions apply to fraudulent financial reporting and misappropriation of assets.a. Trueb. False |
| 68.mediumb | “An attitude, character, or set of ethical values exist that allow management or employees to commit a dishonest act ….” describes the opportunities condition included in the fraud triangle.a. Trueb. False |
| 69.mediumb | Misappropriation of assets is normally perpetrated at the highest levels of the organization hierarchy.a. Trueb. False |
| 70.mediuma | Fraudulent financial reporting usually involves manipulation of amounts rather than disclosures.a. Trueb. False |
| 71.mediumb | An example of a fraud risk factor describing incentives/pressures is “ineffective board of director oversight over financial reporting.”a. Trueb. False |
| 72.mediuma | An example of a fraud risk factor describing opportunities is “ineffective board of director oversight over financial reporting.”a. Trueb. False |
| 73. (Public)mediuma | PCAOB Standard 2 indicates that material fraud by senior management is a material weakness.a. Trueb. False |
| 74.mediuma | Information and idea exchange sessions are required by SAS No. 99.a. Trueb. False |
| 75.mediuma | SAS No. 99 does not specifically indicate which members of an audit engagement team must attend a brainstorming session.a. Trueb. False |
| 76.mediumb | The presence of fraud risk factors increases the likelihood of fraud and usually suggests that fraud is present.a. Trueb. False |
| 77.mediumb | Professional skepticism requires auditors to “either assume that management is dishonest or they have questionable honesty.”a. Trueb. False |
| 78.mediuma | Auditors should consider risk factors related to incentives, opportunities, and attitudes whenever they assess the likelihood of material misstatements due to fraud.a. Trueb. False |
| 79. (Public)challengingb | Auditors must issue a qualified opinion on internal control whenever senior management commits fraud that is considered a material weakness.a. Trueb. False |
| 80.challengingb | The board of directors has the primary responsibility to assess fraud risks and establish corporate governance programs and controls to prevent, deter, and detect fraud.a. Trueb. False |
| 81.challenginga | One of the strongest internal corporate governance mechanisms over senior management is the audit committee of the board of directors.a. Trueb. False |
| 82.challenginga | Because fraud perpetrators are often knowledgeable about audit procedures, SAS No. 99 requires auditors to incorporate unpredictability into the audit plan.a. Trueb. False |
| 83.challenginga | All misstatements the auditor finds during the audit should be evaluated for any indication of fraud.a. Trueb. False |