**Chapter 20 Auditing Theory**

Multiple-Choice Questions

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| 1. | The payroll cycle consists of how many classes of transactions? | | | | | |
| easy | a. one | | | | | |
| a | b. two | | | | | |
|  | c. three | | | | | |
|  | d. four | | | | | |
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| 2. | Which of the following statements is **false**? | | | | | |
| easy | a. The payroll cycle consists of one class of transactions. | | | | | |
| b | b. Balance sheet accounts related to payroll are generally more significant than related transactions. | | | | | |
|  | c. Internal controls over payroll are effective for most companies. | | | | | |
|  | d. Small companies usually have effective controls over payroll. | | | | | |
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| 3. | Which of the following is not correct regarding controls over the processing of payroll? | | | | | |
| easy  b | a. The person authorized to sign paychecks should not be otherwise involved in the preparation of the payroll. | | | | | |
|  | b. A check-signing machine should not be used to replace a manual signature. | | | | | |
|  | c. Distribution of pay checks should be performed by someone who is not involved in the other payroll functions. | | | | | |
|  | d. Unclaimed paychecks should be immediately returned for redeposit. | | | | | |
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| 4. | Which of the following statements about the payroll and personnel cycle is correct? | | | | | |
| Easy |  | | | | | |
| c |  | There are three classes of transactions within the payroll cycle – salaried employees, hourly employees, and commissioned employees. |  | Transactions are less significant than related balance sheet accounts. |  | Internal controls over payroll are effective for almost all companies, even small ones. |
|  | a. | No |  | No |  | Yes |
|  | b. | Yes |  | No |  | Yes |
|  | c. | Yes |  | Yes |  | No |
|  | d. | No |  | Yes |  | No |
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| 5.  easy | Which of the following types of audit procedures is ordinarily emphasized the least when auditing payroll? | | | | | |
| d | a. Tests of controls | | | | | |
|  | b. Tests of transactions | | | | | |
|  | c. Analytical procedures | | | | | |
|  | d. Tests of details of balances | | | | | |
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| 6.  easy | A form issued for each employee summarizing the earnings and income tax deductions for the calendar year is the: | | | | | |
| d | a. rate authorization form. | | | | | |
|  | b. summary payroll report. | | | | | |
|  | c. payroll master file. | | | | | |
|  | d. W-2 form. | | | | | |
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| 7. | The payroll and personnel cycle begins with which of the following events? | | | | | |
| easy | a. Interviewing job candidates. | | | | | |
| b | b. Hiring a new employee. | | | | | |
|  | c. Existing employees submitting requests for payment for work performed. | | | | | |
|  | d. Issuance of paychecks. | | | | | |
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| 8. | Most systems of internal control for payroll are: | | | | | |
| easy | a. loosely structured but well controlled. | | | | | |
| c | b. loosely structured and loosely controlled. | | | | | |
|  | c. highly structured and well controlled. | | | | | |
|  | d. highly structured but loosely controlled. | | | | | |
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| 9. | The payroll and personnel cycle ends with which of the following events? | | | | | |
| easy | a. Interviewing job candidates. | | | | | |
| d | b. Hiring a new employee. | | | | | |
|  | c. Existing employees submitting requests for payment for work performed. | | | | | |
|  | d. Issuance of paychecks. | | | | | |
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| 10.  easy | The retirement savings deductions, number of exemptions for withholding allowances, union dues deductions, and other deductions are found on what form? | | | | | |
| b | a. Time cards | | | | | |
|  | b. Deduction authorization form | | | | | |
|  | c. Rate authorization form | | | | | |
|  | d. Job time ticket | | | | | |
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| 11.  easy | A \_\_\_\_\_\_\_\_\_\_\_\_ includes all payroll transactions processed by the accounting system for a given period of time. | | | | | |
| b | a. payroll journal | | | | | |
|  | b. payroll transaction file | | | | | |
|  | c. time report | | | | | |
|  | d. payroll summary | | | | | |
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| 12. | An imprest payroll account ordinarily carries a balance that is: | | | | | |
| easy | a. larger than the other company bank accounts. | | | | | |
| c | b. larger than the amount of the periodic payroll disbursement. | | | | | |
|  | c. small. | | | | | |
|  | d. below zero. | | | | | |
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| 13. | Records that include data such as employment date, performance ratings and pay rates are the: | | | | | |
| easy | a. personnel records. | | | | | |
| a | b. employee screening forms. | | | | | |
|  | c. summary payroll reports. | | | | | |
|  | d. employee folders. | | | | | |
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| 14.  easy | In audits of companies in which payroll is a significant portion of inventory, the improper account classification of payroll can: | | | | | | | | |
| a |  | | | | | | | | |
|  |  | Increase asset valuations. | | |  | Decrease asset valuations. | | |
|  | a. | Yes | | |  | Yes | | | |
|  | b. | No | | |  | No | | | |
|  | c. | Yes | | |  | No | | | |
|  | d. | No | | |  | Yes | | | |
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| 15. | To minimize the opportunity for fraud, unclaimed salary checks should be: | | | | | | | | |
| easy | a. deposited in a special bank account. | | | | | | | | |
| a | b. kept in the payroll department. | | | | | | | | |
|  | c. left with the employee’s supervisor. | | | | | | | | |
|  | d. held for the employee in the personnel department. | | | | | | | | |
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| 16. | Which of the following type of employee typically does **not** complete time cards? | | | | | | | | |
| medium | a. Hourly employees. | | | | | | | | |
| b | b. Salaried employees. | | | | | | | | |
|  | c. All employees must complete time cards. | | | | | | | | |
|  | d. Time cards are typically completed by salaried employees, but may also be completed by hourly employees. | | | | | | | | |
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| 17. | When examining payroll transactions, an auditor is primarily concerned with the possibility of: | | | | | | | | |
| medium | a. incorrect summaries of employee time records. | | | | | | | | |
| b | b. overpayments and unauthorized payments. | | | | | | | | |
|  | c. under withholding of amounts required to be withheld. | | | | | | | | |
|  | d. posting of gross payroll amounts to incorrect salary expense accounts. | | | | | | | | |
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| 18.  medium  a | For which of the following functions is the use of prenumbered documents least important?   1. Use of prenumbered time cards in the payroll function. 2. Use of prenumbered sales invoices in the sales function. 3. Use of prenumbered receiving reports in the acquisitions function. 4. Use of prenumbered deposit slips in the cash receipts function. | | | | | | | | |
| 19. | Which of the following statements about payroll checks is correct? | | | | | | | | |
| medium  b | a. After a payroll check is cashed and returned to the employee it is referred to as a depository check. | | | | | | | | |
|  | b. As soon as a payroll check is signed by an authorized employee, it becomes an asset. | | | | | | | | |
|  | c. Payroll checks are written for the amount of gross pay due employees. | | | | | | | | |
|  | d. It is rare that payroll checks are direct-deposited into employees’ bank accounts. | | | | | | | | |
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| 20. | Which of the following is **not** an advantage of using an imprest payroll account? | | | | | | | | |
| medium | a. It limits the company’s exposure to payroll fraud. | | | | | | | | |
| c | b. It allows the delegation of payroll check-signing duties. | | | | | | | | |
|  | c. Companies have fewer banking transactions. | | | | | | | | |
|  | d. It facilitates cash management. | | | | | | | | |
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| 21.  medium | No individual with access to time cards, payroll records, or checks should also be permitted access to: | | | | | | | | |
| c | a. the computer. | | | | | | | | |
|  | b. job time tickets. | | | | | | | | |
|  | c. personnel records. | | | | | | | | |
|  | d. the canceled check file. | | | | | | | | |
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| 22.  medium | The file for recording each payroll transaction for each employee and maintaining total employee wages paid for the year to date is the: | | | | | | | | |
| a | a. payroll master file. | | | | | | | | |
|  | b. summary payroll report. | | | | | | | | |
|  | c. payroll journal. | | | | | | | | |
|  | d. job time ticket. | | | | | | | | |
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| 23.  medium | Many companies use outside payroll services to process payroll. Auditors \_\_\_\_\_ rely on the internal controls of these outside payroll services. | | | | | | | | |
| d | a. must | | | | | | | | |
|  | b. cannot | | | | | | | | |
|  | c. rarely | | | | | | | | |
|  | d. can often | | | | | | | | |
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| 24. | The total of the individual employee earnings in the payroll master file equals the total: | | | | | | | | |
| medium | a. balance of gross payroll in general ledger accounts. | | | | | | | | |
| a | b. of the checks drawn to employees for payroll. | | | | | | | | |
|  | c. gross payroll plus the total contributed by the employer for payroll taxes. | | | | | | | | |
|  | d. gross pay for the current week’s payroll. | | | | | | | | |
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| 25.  medium | If auditors rely on the internal controls of an outside payroll service provider, they will receive a(n) \_\_\_\_\_ report. | | | | | | | | |
| b | a. reliance | | | | | | | | |
|  | b. SAS 70 | | | | | | | | |
|  | c. outsourcer’s | | | | | | | | |
|  | d. quality assurance | | | | | | | | |
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| 26.  medium | Most companies use an imprest account to pay the payroll. Which of the following is **not** an advantage of such an account? | | | | | | | | |
| d | a. It facilitates cash management. | | | | | | | | |
|  | b. It limits the company’s exposure to payroll fraud. | | | | | | | | |
|  | c. It allows the delegation of payroll check-signing duties. | | | | | | | | |
|  | d. It eliminates the requirement of keeping a minimum balance in a checking account. | | | | | | | | |
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| 27.  medium | The careful and timely preparation of all payroll tax returns is necessary to avoid penalties and criminal charges. The most important control in the timely preparation of these returns is: | | | | | | | | |
| b | a. computerized preparation of tax returns. | | | | | | | | |
|  | b. a well-defined set of policies that indicate when each form must be filed. | | | | | | | | |
|  | c. independent verification of computer output by a competent individual. | | | | | | | | |
|  | d. a Gaant chart. | | | | | | | | |
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| 28.  medium | Which of the following types of audit tests is usually emphasized due to a lack of independent third-party evidence related to payroll transactions? | | | | | | | | |
| c | a. Analytical procedures | | | | | | | | |
|  | b. Tests of details of balances | | | | | | | | |
|  | c. Tests of controls | | | | | | | | |
|  | d. Each of the above is emphasized. | | | | | | | | |
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| 29. | The most important means of verifying account balances in the payroll and personnel cycle are: | | | | | | | | |
| medium | a. tests of controls and tests of transactions. | | | | | | | | |
| a | b. analytical procedures and tests of controls. | | | | | | | | |
|  | c. analytical procedures and tests of transactions. | | | | | | | | |
|  | d. test of controls and tests of details of balances. | | | | | | | | |
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| 30. | Tests of payroll are usually not extensive because: | | | | | | | | |
| Medium |  | | | | | | | | |
| a |  | employees will likely complain if underpaid. |  | payroll transactions are uniform and uncomplicated. | | |  | payroll transactions are subject to audit by federal and state governments. | |
|  | a. | Yes |  | Yes | | |  | Yes | |
|  | b. | No |  | Yes | | |  | No | |
|  | c. | No |  | No | | |  | Yes | |
|  | d. | Yes |  | No | | |  | No | |
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| 31.  medium | If an auditor wishes to test the completeness transaction-related audit objective in the payroll and personnel cycle, which of the following would be a reasonable test of control? | | | | | | | | |
| a | a. Account for a sequence of payroll checks. | | | | | | | | |
|  | b. Examine procedures manual and observe the recording of transactions. | | | | | | | | |
|  | c. Examine payroll records for indication of pay rate approval. | | | | | | | | |
|  | d. Reconcile the payroll bank account. | | | | | | | | |
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| 32. | Which of the following is a substantive test of transactions? | | | | | | | | |
| medium | a. Review personnel policies. | | | | | | | | |
| c | b. Account for a sequence of payroll checks. | | | | | | | | |
|  | c. Reconcile the disbursements in the payroll journal with the disbursements on the payroll bank statement. | | | | | | | | |
|  | d. Examine printouts of transactions rejected by the computer as having invalid employee IDs. | | | | | | | | |
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| 33.  medium | As a part of the auditor’s responsibility for \_\_\_\_\_\_\_\_\_\_\_\_, the auditor should review the preparation of at least one of each type of payroll tax form the client is responsible for filing. | | | | | | | | |
| d | a. doing tests of controls. | | | | | | | | |
|  | b. doing tests of balances. | | | | | | | | |
|  | c. doing tests of transactions. | | | | | | | | |
|  | d. understanding the client’s internal controls. | | | | | | | | |
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| 34.  medium | Which of the following is **not** an assertion related to the classes of transactions underlying the payroll cycle? | | | | | | | | |
| c | a. Classification | | | | | | | | |
|  | b. Accuracy | | | | | | | | |
|  | c. Existence | | | | | | | | |
|  | d. Occurrence | | | | | | | | |
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| 35.  medium | Which of the following circumstances would **not** cause an auditor to extend payroll procedures considerably? | | | | | | | | |
| d | a. Payroll significantly affects inventory valuation. | | | | | | | | |
|  | b. There is a possibility of material fraudulent payroll transactions. | | | | | | | | |
|  | c. There is a weak internal control structure. | | | | | | | | |
|  | d. There is a lack of independent third-party evidence, such as confirmations. | | | | | | | | |
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| 36.  medium | When labor is a material factor in inventory valuation, the auditor should place special emphasis on testing the internal controls concerning: | | | | | | | | |
| c | a. fictitious employees. | | | | | | | | |
|  | b. authorization of wage rates. | | | | | | | | |
|  | c. proper valuation and allocation of balances. | | | | | | | | |
|  | d. completeness of recorded transactions. | | | | | | | | |
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| 37.  medium | Which of the following is **not** a procedure that can be performed on canceled checks in an effort to detect defalcations? | | | | | | | | |
| d | a. Compare the endorsements on checks with authorized signatures. | | | | | | | | |
|  | b. Scan endorsements for unusual or recurring second endorsements. | | | | | | | | |
|  | c. Examine voided checks to be sure they haven’t been used. | | | | | | | | |
|  | d. Examine the payroll records in subsequent periods to determine that terminated employees are no longer being paid. | | | | | | | | |
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| 38.  medium | What potential problems may arise when an auditor considers the relationship between payroll and inventory valuation? | | | | | | | | | | |
| d |  | | | | | | | | | | |
|  |  | Improper account classification. |  | Improper allocation to jobs or processes. | | | | |  | Non-manufacturing payroll expenses charged to inventory. | |
|  | a. | Yes |  | Yes | | | | |  | Yes | |
|  | b. | No |  | Yes | | | | |  | No | |
|  | c. | No |  | No | | | | |  | Yes | |
|  | d. | Yes |  | No | | | | |  | No | |
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| 39. | The primary concern in testing payroll-related liabilities is to make sure that: | | | | | | | | | | |
| medium | a. accruals are properly valued. | | | | | | | | | | |
| c | b. transactions are recorded in the proper period. | | | | | | | | | | |
|  | c. there are no understated or omitted accruals. | | | | | | | | | | |
|  | d. the accruals are not overstated. | | | | | | | | | | |
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| 40.  medium | Which department should be authorized to add and delete employees from the payroll or change pay rates and deductions? | | | | | | | | | | |
| c | a. The supervising department. | | | | | | | | | | |
|  | b. The accounting department. | | | | | | | | | | |
|  | c. The human resources department. | | | | | | | | | | |
|  | d. The treasurer’s department. | | | | | | | | | | |
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| 41. | Paychecks should be distributed by someone: | | | | | | | | | | |
| Medium |  | | | | | | | | | | |
| c |  | independent of the timekeeping function. | | | | |  | who reports to the company controller. | | |
|  | a. | Yes | | | | |  | Yes | | | |
|  | b. | No | | | | |  | No | | | |
|  | c. | Yes | | | | |  | No | | | |
|  | d. | No | | | | |  | Yes | | | |
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| 42.  medium | Verification of the legitimacy of year-end unpaid bonuses to officers and employees can be accomplished by comparing the recorded accrual to the amount: | | | | | | | | | | |
| c | a. in the expense account. | | | | | | | | | | |
|  | b. used in the prior period. | | | | | | | | | | |
|  | c. authorized in the minutes of the board. | | | | | | | | | | |
|  | d. paid in the subsequent period. | | | | | | | | | | |
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| 43.  medium | Which of the following errors gives the auditor the least concern in auditing payroll transactions? | | | | | | | | | | |
| d | a. An error that indicates possible fraud. | | | | | | | | | | |
|  | b. Computational errors in formulas when a computerized system is used. | | | | | | | | | | |
|  | c. Classification errors in charging labor to inventory and job cost accounts. | | | | | | | | | | |
|  | d. Each of the above gives the auditor significant concern. | | | | | | | | | | |
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| 44. (Public)  medium | The usual audit test for a public company’s officer compensation is to obtain the authorized salary of each officer from the minutes of the board of directors and compare it with: | | | | | | | | | | |
| a |  |  | | |  |  | | | | |
|  |  | the SEC’s 10-K report. | | |  | the company’s federal income tax return. | | | | |
|  | a. | Yes | | |  | Yes | | | | | |
|  | b. | No | | |  | No | | | | | |
|  | c. | Yes | | |  | No | | | | | |
|  | d. | No | | |  | Yes | | | | | |
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| 45. | Auditors may extend their tests of payroll in which of the following circumstances? | | | | | | | | | | |
| Medium |  | | | | | | | | | | |
| a |  | Payroll materially affects the valuation of inventory. | | |  | The auditor is concerned there may be nonexistent employees on the payroll. | | | | |
|  | a. | Yes | | |  | Yes | | | | | |
|  | b. | No | | |  | No | | | | | |
|  | c. | Yes | | |  | No | | | | | |
|  | d. | No | | |  | Yes | | | | | |
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| 46. | To check the accuracy of hours worked, an auditor would ordinarily compare clock cards with: | | | | | | | | | | |
| medium | a. personnel records. | | | | | | | | | | |
| b | b. job time tickets. | | | | | | | | | | |
|  | c. labor variance reports. | | | | | | | | | | |
|  | d. time recorded in the payroll register. | | | | | | | | | | |
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| 47.  medium | A surprise payroll payoff in which employees must pick-up and sign for their pay check is one means of: | | | | | | | | | | |
| c | a. identifying employees who do not have proper work credentials. | | | | | | | | | | |
|  | b. establishing a tightly controlled, fraud-free work environment . | | | | | | | | | | |
|  | c. testing for nonexistent employees. | | | | | | | | | | |
|  | d. identifying employees who have not submitted proper W-2 forms.. | | | | | | | | | | |
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| 48.  medium | Which of the following is the best way for an auditor to determine that every name on a company’s payroll is that of a bona fide employee presently on the job? | | | | | | | | | | |
| c | a. Examine personnel records for accuracy and completeness. | | | | | | | | | | |
|  | b. Examine employees’ names listed on payroll tax returns for agreement with payroll accounting records. | | | | | | | | | | |
|  | c. Make a surprise observation of the company’s regular distribution of paychecks. | | | | | | | | | | |
|  | d. Visit the working areas and confirm with employees their badge or identification numbers. | | | | | | | | | | |
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| 49. | Inherent risk is typically \_\_\_\_\_ for balance-related audit objectives as they relate to payroll. | | | | | | | | | | |
| medium | a. not considered | | | | | | | | | | |
| b | b. low | | | | | | | | | | |
|  | c. moderate | | | | | | | | | | |
|  | d. high | | | | | | | | | | |
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| 50.  medium | It would be appropriate for the payroll department to be responsible for which of the following functions? | | | | | | | | | | |
| d | a. Approval of employee time records. | | | | | | | | | | |
|  | b. Maintain records of employment, firings, and raises. | | | | | | | | | | |
|  | c. Temporary retention of unclaimed employee paychecks. | | | | | | | | | | |
|  | d. Preparation of governmental reports as to employees’ earnings and withholding taxes. | | | | | | | | | | |
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| 51. | What are the two major balance-related audit objectives in testing payroll liabilities? | | | | | | | | | | |
| medium | a. Accuracy and detail tie-in | | | | | | | | | | |
| d | b. Completeness and valuation | | | | | | | | | | |
|  | c. Completeness and rights and obligations | | | | | | | | | | |
|  | d. Accuracy and cutoff | | | | | | | | | | |
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| 52. | Which of the following best describes proper internal control over payroll? |
| medium | a. The preparation of the payroll must be under the control of the personnel department. |
| c | b. The confidentiality of employee payroll data should be carefully protected to prevent fraud. |
|  | c. The duties of hiring, payroll computation, and payment to employees should be segregated. |
|  | d. The payment of cash to employees should be replaced with payment by checks. |
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| 53.  medium | The periodic payment from the general cash account to the payroll account for net payroll should be tested for at least one payroll period. The primary audit procedure is a(n): |
| d | a. analytical review procedure that net pay is reasonable. |
|  | b. test of controls that an imprest account is being used for payroll. |
|  | c. substantive test that the correct amount was transferred for this test period. |
|  | d. test of transactions that the check is prepared for the proper amount and deposited before payroll checks are handed out. |
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| 54.  challenging | Once the auditor determines that the company’s policy for accruing wages is consistent with prior years, the appropriate audit procedure to test for accuracy and cutoff is: |
| a | a. recalculating the client’s accrual. |
|  | b. performing extensive tests of controls. |
|  | c. performing extensive tests of details. |
|  | d. none of the above. |
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| 55.  challenging | In auditing payroll, which of the following procedures will ordinarily require the least amount of auditor time under normal circumstances? |
| d | a. Tests of controls. |
|  | b. Substantive tests of transactions. |
|  | c. Analytical procedures. |
|  | d. Tests of details of balances. |
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| 56.  challenging  a | A weak internal control system allows a department supervisor to “clock in” for a fictitious employee and then approve the employee’s time card at the end of the pay period. This fraud would be detected if other controls were in place, such as having an independent party: |
|  | a. distribute paychecks. |
|  | b. recompute hours worked from time cards. |
|  | c. foot the payroll journal and trace postings to the general ledger and the payroll master file. |
|  | d. compare the date of the recorded check in the payroll journal with the date on the canceled checks and time cards. |
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| 57.  challenging | The most important consideration in evaluating the fairness of the amounts accrued for vacation pay, sick pay, and other benefits is the: |
| a | a. consistent accrual of these liabilities relative to those of preceding periods. |
|  | b. actual expense incurred for the prior period. |
|  | c. amount expended to date in the current period. |
|  | d. profitability of the client which will enable these liabilities to be met. |
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| 58.  challenging | Effective internal accounting control over unclaimed payroll checks that are kept by the company would include accounting department procedures that require: |
| d | a. effective cancellation and stop payment orders for checks representing unclaimed wages. |
|  | b. preparation of a list of unclaimed wages on a periodic basis. |
|  | c. accounting for all unclaimed wages in a current liability account. |
|  | d. periodic accounting for the actual checks representing unclaimed wages. |
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| 59.  challenging | Which of the following internal controls in the payroll and personnel cycle is generally least important to an auditor? |
| b | a. Formal methods of informing payroll personnel of new employees. |
|  | b. Reconciliation of total payroll expense in the general ledger with the payroll tax returns and the W-2 forms. |
|  | c. Authorization of changes in pay rates. |
|  | d. Notice of the termination date of employees no longer working for the company. |
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| 60. | Which of the following statements is correct? |
| challenging  d | a. The overhead charged to inventory at the balance sheet date can be understated if the salaries of administrative personnel are inadvertently or intentionally charged to indirect manufacturing overhead. |
|  | b. When jobs are billed on a cost-plus basis, revenue and total expenses are both affected by charging labor to incorrect jobs. |
|  | c. Payroll is a significant portion of inventory for retail and service industry companies. |
|  | d. The valuation of inventory is affected if the direct labor cost of individual employees is improperly charged to the wrong job or process. |
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| 61.  challenging | Which of the following is an effective internal accounting control used to prove that production department employees are properly validating payroll time cards at a time-recording station? |
| d | a. Internal auditors should make observations of distribution of paychecks on a surprise basis. |
|  | b. Time cards should be carefully inspected by those persons who distribute pay envelopes to the employees. |
|  | c. One person should be responsible for maintaining records of employee time for which salary payment is not to be made. |
|  | d. Daily reports showing time charged to jobs should be approved by the supervisor and compared to the total hours worked on the employee time cards. |
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| 62.  challenging  a | Once the auditor has determined the company’s policy for accruing wages and knows it is consistent with that of previous years, the appropriate audit procedure to test for cutoff and accuracy is to: |
|  | a. recalculate the client’s accruals. |
|  | b. compare the ledger balance with the journal and the tax form. |
|  | c. confirm the amount with employees. |
|  | d. compare the recorded accrued wages with the amount approved in the minutes of the Board. |
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Essay Questions

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| 63.  easy | What are two possible reasons that internal controls over payroll are effective for most companies? |
|  | Answer:  Harsh federal and state penalties encourage effective controls for withholding and paying payroll taxes. Also, employee morale problems can occur if employees are not paid or are underpaid. |

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| 64.  easy | What events initiate and terminate the payroll and personnel cycle? |
|  | Answer:  The hiring of an employee initiates the cycle and the payments to employees, governments, and other organizations terminate the cycle. |
| 65.  easy | What types of audit procedures are typically emphasized during the audit of the payroll cycle? |
|  | Answer:  Auditors typically emphasize tests of controls, tests of transactions and analytical procedures. |
| 66.  easy | Discuss the procedures involved in, and the purpose of, a surprise payroll payoff. |
|  | Answer:  A surprise payroll payoff is a procedure in which each employee must pick up and sign for his or her check in the presence of a supervisor and the auditor. Any checks that are not claimed are subject to an extensive investigation to determine whether an unclaimed check is fraudulent. The purpose is to test for nonexistent employees; that is, the issuance of payroll checks to individuals who do not work for the company. |
| 67.  medium | Discuss three important differences between the payroll and personnel cycle and other cycles in a typical audit. |
|  | Answer:  Three important differences between the payroll and personnel cycle and other cycles in a typical audit are:   * There is only one class of transactions for payroll, whereas most cycles include at least two classes of transactions. * In the payroll cycle, transactions are far more significant than related balance sheet accounts. * Internal controls over payroll are effective for almost all companies, even small ones. This is primarily due to severe federal and state penalties for errors in withholding and paying payroll taxes and employee morale problems if employees are not paid or are underpaid. |
| 68.  medium | What key separation of duties should the auditor expect to find within the payroll and personnel cycle? |
|  | Answer:  The human resources department should be independent of the payroll function and should be responsible for hiring and terminating employees, as well as changes in pay rates and deductions. In additional payroll processing should be separate from the custody of signed payroll checks. |

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| 69.  medium | Discuss each of the following primary documents and records used in the personnel and employmentfunction in the payroll and personnel cycle: personnel records, deduction authorization form, and the rate authorization form. |
|  | Answer:   * *Personnel records*. These records include employees’ date of employment, personnel investigations, rates of pay, authorized deductions, performance evaluations, and termination of employment. * *Deduction authorization form*. This form authorizes payroll deductions, including the number of exemptions for withholding of income taxes, U.S. savings bonds, and union dues. * *Rate authorization form.* This form authorizes employees’ rate of pay. |
| 70.  medium | Discuss each of the following documents and records used in the timekeeping and payroll preparationfunction in the payroll and personnel cycle: time card, job time ticket, summary payroll report, payroll journal and payroll master file. |
|  | Answer:  The primary documents and records used in the timekeeping and payroll preparation function are:   * *Time card*. The time card is used to indicate the time the employee started and stopped working each day and the number of hours the employee worked. * *Job time ticket.* This document indicates jobs on which a factory employee worked during a given time period. This form is used only when an employee works on different jobs or in different departments. * *Summary payroll report.* This report summarizes payroll for a period. * *Payroll journal*. This journal is used to record payroll checks. * *Payroll master file.* This file contains each payroll transaction for each employee, along with total employee wages paid for the year to date. |
| 71.  medium | Discuss each of the following primary documents and records used in the (1) payment of payroll function, and (2) preparation of payroll tax returns and payment of taxes function in the payroll and personnel cycle: payroll check, W-2 form, and payroll tax returns. |
|  | Answer:  The primary documents and records used in the payment of payroll function and the preparation of payroll tax returns and payment of taxes function are:   * *Payroll check*. This is a check written to the employee for services performed. * *W-2 form.* This form is issued for each employee summarizing the earnings record for the calendar year. * *Payroll tax returns*. These are tax forms submitted to local, state, and federal units of government for the payment of withheld taxes and the employer’s tax. |
| 72.  medium | There are several key internal controls over the payment of payroll function that should be present. For example, the payroll should be distributed by someone who is not involved in the other payroll functions. Discuss other key internal controls over the payment of payroll function. |

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|  | Answer:  Controls over payroll checks should include limiting the authorization for signing the checks to a responsible employee who does not have access to timekeeping or the preparation of the payroll, and the immediate return of unclaimed checks for redeposit. If a check-signing machine is used to replace a manual signature, the machine must be carefully controlled. An imprest payroll account can be used to prevent the payment of unauthorized payroll transactions. |
| 73.  medium | Discuss the advantages of using an imprest payroll account. |
|  | Answer:  The advantages of an imprest account are that it limits the client’s exposure to payroll fraud, allows the delegation of payroll check-signing duties, separates routine payroll expenditures from irregular expenditures, and facilitates cash management. It also simplifies the reconciliation of the payroll bank account. |
| 74.  medium | Discuss the two circumstances under which auditors would extend their procedures considerably in the audit of payroll. |
|  | Answer:  Auditors often extend their procedures considerably in the audit of payroll under the following circumstances: (1) when payroll significantly affects the valuation of inventory and (2) when the auditor is concerned about the possibility of material fraudulent payroll transactions. |
| 75.  medium | How do auditors commonly verify sales commission expense? |
|  | Answer:  If all employees receive the same commission rate, then verifying the expense is done by multiplying the commission rate by the amount of the sales. If there are different commission rates, then the auditor will likely select a sample of employees to examine separately on a monthly or annual basis. |
| 76.  medium | What is one audit procedure that may be used to test for proper handling of terminated employees? |
|  | Answer:  A procedure that tests for proper handling of terminated employees is to select several files from the personnel records for employees who were terminated in the current year to determine whether each received termination pay consistent with company policy. Continuing payments to terminated employees can be tested by examining payroll records in the subsequent period to verify that the employee is no longer being paid. Naturally, this procedure is not effective if the personnel department is not informed of terminations. |

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| 77.  challenging | There are several internal controls in the personnel and employment function that are important from an audit perspective. For example, there should be an adequate investigation of the competence and trustworthiness of new employees. Discuss other internal controls in the personnel and employment function that are important from an audit perspective. |
|  | Answer:  From an audit perspective, the most important internal controls in personnel involve formal methods of informing the timekeeping and payroll preparation personnel of new employees, the authorization of initial and periodic changes in pay rates, and the termination date of employees no longer working for the company. As part of these controls, segregation of duties is extremely important. No individual with access to time cards, payroll records, or checks should also be permitted access to personnel records. |
| 78.  challenging | There are several key internal controls over the timekeeping and payroll preparation function that should be present. For example, adequate control over the time on employees’ time cards includes the use of a time clock or other method of making certain that employees are paid for the number of hours they worked. Discuss other key internal controls over the timekeeping and payroll preparation function. |
|  | Answer:  Internal controls over the timekeeping and payroll preparation function should include controls to prevent anyone from checking in for several employees or submitting a fraudulent time card. The summarization and calculation of the payroll can be controlled by well-defined policies for the payroll department, separation of duties to provide automatic cross-checks, reconciliation of payroll hours with independent production records, and independent internal verification of all important data. Controls over the preparation of payroll checks include preventing those responsible for preparing the checks from having access to time cards, signing or distributing checks, or independently verifying payroll output. In addition, the checks should be prenumbered and verified through independent bank reconciliation procedures. |

Other Objective Answer Format Questions

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| 79.  medium | Match seven of the terms for documents and records (a-k) used in the payroll and personnel cycle with the descriptions provided below (1-7): |
|  | a. Personnel records |
|  | b. Deduction authorization form |
|  | c. Rate authorization form |
|  | d. Time card |
|  | e. Job time ticket |
|  | f. Summary payroll report |
|  | g. Payroll check |
|  | h. W-2 form |
|  | i. Payroll tax returns |
|  | j. Payroll journal |
|  | k. Payroll master file |
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| k | 1. A file used for recording payroll transactions for each employee and maintaining total employee wages paid for the year to date. |
| d | 2. A document indicating the time the hourly employee stated and stopped working. |
| g | 3. A document written in exchange for services received from an employee. |
| i | 4. Forms submitted to local, state, and federal units of government for the payment of withheld taxes and the employer’s tax. |
| b | 5. A form authorizing payroll deductions, including the number of exemptions for withholding of income taxes, U.S. savings bonds, and union dues. |
| c | 6. A form used to authorize the amount of pay. |
| a | 7. Records including date of employment, personnel investigations, rates of pay, etc. |
| 80.  easy  b | Payroll checks do not need to be distributed by someone independent of the payroll and timekeeping functions.   1. True 2. False |
| 81.  easy  a | Hiring personnel initiates the payroll and personnel cycle.  a. True  b. False |
| 82.  easy  b | Firing personnel terminates the payroll and personnel cycle.  a. True  b. False |
| 83.  easy  a | Paying employees for their services ends the payroll and personnel cycle.  a. True  b. False |

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| 84.  easy  a | Auditors seldom expect to find misstatements when testing payroll transactions.  a. True  b. False |
| 85.  easy  b | Most companies, with the exception of small ones, have effective controls over the payroll cycle.  a. True  b. False |
| 86.  easy  a | The nature, extent, and timing of substantive tests of payroll transactions vary depending, in part, on assessed control risk.  a. True  b. False |
| 87.  easy  b | Inherent risk for payroll-related liabilities is normally higher than for accounts receivable.  a. True  b. False |
| 88.  easy  a | While most cycles include at least two classes of transactions, the payroll and personnel cycle includes only one class of transactions.  a. True  b. False |
| 89.  easy  b | “Physical control over assets” is not a type of control that is applicable to the payroll cycle.  a. True  b. False |
| 90.  easy  b | The deduction authorization form authorizes the rate of pay and the deductions for taxes, dues, etc.  a. True  b. False |
| 91.  easy  a | When auditing the payroll and personnel cycle, tests of controls are routinely performed.  a. True  b. False |
| 92.  easy  b | When labor is a material part of inventory, auditors should emphasize tests of details of balances.  a. True  b. False |
| 93.  easy  a | A signed payroll check that has not been cashed is considered an asset to the company that issued the check.  a. True  b. False |
| 94.  easy  a | For proper internal control, the person(s) responsible for signing the payroll checks should not have access to timekeeping or be otherwise involved in the preparation of payroll.  a. True  b. False |

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| 95.  easy  b | The job time ticket indicates the starting and stopping times of work during the pay period.  a. True  b. False |
| 96.  easy  a | The use of an imprest payroll account prevents losses from payment of unauthorized payroll to no more than the balance in the imprest account.  a. True  b. False |
| 97.  easy  b | Imprest accounts usually carry a significant balance.  a. True  b. False |
| 98.  easy  a | There is very little opportunity for confirmation from third parties of balance sheet accounts related to the payroll and personnel cycle.  a. True  b. False |
| 99.  medium  a | When a client uses an outside payroll service for processing payroll, professional auditing standards permit the auditor to rely on the internal controls of the service organization if the service organization’s auditor has issued a favorable report on the internal controls of the service organization.   1. True. 2. False. |
| 100.  medium  b | When a client uses an outside payroll service for processing payroll, professional auditing standards require the auditor to rely on the internal controls of the service organization if the service organization’s auditor has issued a favorable report on internal controls.   1. True. 2. False. |
| 101.  medium  a | For good internal control, the payroll function should be independent of the personnel department.   1. True. 2. False. |
| 102. (Public)  medium  b | If an audit client is a public company, the understanding of internal control must be sufficient to identify opportunities to increase audit effectiveness.  a. True  b. False |
| 103.  medium  b | Tests of controls and tests of details of balances are the auditor’s most important means of verifying account balances in the payroll and personnel cycle.  a. True  b. False |
| 104.  medium  b | Because of the cycle’s pervasive nature, audit tests of the payroll cycle are usually extensive.  a. True  b. False |

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| 105.  medium  b | The primary purpose of a surprise payroll payoff is to detect employees who have reported more time than was actually worked (fraudulent hours).  a. True  b. False |
| 106.  medium  a | The two major balance-related audit objectives in testing payroll liabilities are accuracy and cutoff.  a. True  b. False |
| 107.  medium  b | Because of confidentiality requirements and potential losses of payroll funds, outside service center systems are rarely used by companies for payroll-related functions.  a. True  b. False |
| 108.  medium  a | Internal control over payroll is normally highly structured and well controlled.  a. True  b. False |
| 109.  medium  b | Supervisory personnel in the functional department responsible for evaluating employees should be responsible for authorizing the addition and deletion of employees from the payroll.  a. True  b. False |
| 110.  medium  a | Despite the large dollar amounts involved in the payroll and personnel cycle, auditors typically spend less time auditing this cycle than others.  a. True  b. False |
| 111.  medium  a | It is generally more difficult for the auditor to detect payment of fraudulent hours than payment of fictitious employees.  a. True  b. False |
| 112.  medium  a | One common substantive test of payroll transactions for the existence objective is to compare canceled payroll checks with personnel records.  a. True  b. False |
| 113.  medium  b | The audit procedure “Recompute hours worked from time cards” is normally performed when testing the completeness objective for payroll.  a. True  b. False |
| 114.  challenging  a | In most audits, payroll tax expense is not tested because the audit risk does not justify the time required to perform the tests.  a. True  b. False |