

Auditing and Assurance Services, 14e (Arens)
Chapter 11 Fraud Auditing

Learning Objective 11-1

1) Which of the following best defines fraud in a financial statement auditing context?

- A) Fraud is an unintentional misstatement of the financial statements.
- 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.

Answer: B

Terms: Definition of fraud in financial statement auditing

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

2) Companies may intentionally understate earnings when income is high to create a reserve of "earnings" that may be used in future years to increase earnings. This practice is known as:

- A) performance-based management.
- B) earnings management.
- C) asset management.
- D) expense management.

Answer: B

Terms: Intentionally understate earnings; Reserve earnings

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

3) Which of the following is a category of fraud?

A)

Fraudulent financial reporting	Misappropriation of assets
Yes	Yes

B)

Fraudulent financial reporting	Misappropriation of assets
No	No

C)

Fraudulent financial reporting	Misappropriation of assets
Yes	No

D)

Fraudulent financial reporting	Misappropriation of assets
No	Yes

Answer: A

Terms: Category of fraud

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

4) With respect to misappropriation of assets, most frauds involve:

A)

Inventory or liquid asset theft	Intentional misstatements of amounts
Yes	Yes

B)

Inventory or liquid asset theft	Intentional misstatements of amounts
No	No

C)

Inventory or liquid asset theft	Intentional misstatements of amounts
Yes	No

Yes No

D)

Inventory or liquid asset theft	Intentional misstatements of amounts
No	Yes

Answer: C

Terms: Misappropriation of assets fraud

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

5) _____ is fraud that involves theft of an entity's assets.

- A) Fraudulent financial reporting
- B) A "cookie jar" reserve
- C) Misappropriation of assets
- D) Income smoothing

Answer: C

Terms: Fraud that involves theft of entity's assets

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

6) Which of the following would the auditor be most concerned about regarding a heightened risk of intentional misstatement?

- A) senior management emphasizes that it is very important to beat analyst estimates of earnings every reporting period
- B) senior management emphasizes that budgeted amounts for expenses are to be achieved for each reporting period or explained in the variance analysis report
- C) senior management emphasizes that job rotation is a worthwhile corporate objective
- D) senior management emphasizes that job evaluations are based on performance

Answer: A

Terms: Heightened risk of intentional misstatement

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

7) Which of the following is a form of earnings management in which revenues and expenses are shifted between periods to reduce fluctuations in earnings?

- A) fraudulent financial reporting
- B) expense smoothing
- C) income smoothing
- D) each of the above is correct

Answer: C

Terms: Form of earnings management where revenues and expenses are shifted between periods

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

8) Who is most likely to perpetrate fraudulent financial reporting?

- A) members of the board of directors
- B) production employees
- C) management of the company
- D) the internal auditors

Answer: C

Terms: Fraudulent financial reporting

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

9) Misappropriation of assets is normally perpetrated by:

- A) members of the board of directors.
- B) employees at lower levels of the organization.
- C) management of the company.
- D) the internal auditors.

Answer: B

Terms: Misappropriation of assets normally perpetrated by

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

10) Determine from the following the factor that would most likely elevate the auditor's concern about the risk of financial statement fraud.

- A) company cannot borrow debt capital without restrictive covenants
- B) company finds it difficult to sell equity capital for expansion
- C) company has a significant portion of liquid assets on its balance sheet
- D) company reports substantial net income but ever decreasing cash flow from operations

Answer: D

Terms: Most likely elevate auditor's concern about risk of financial statement fraud

Diff: Moderate

Objective: LO 11-1

AACSB: Analytic skills

11) 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.

Terms: Fraud and main categories

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

12) In the context of financial statement auditing, fraud is defined as an intentional misstatement of a material fact regarding balances, transactions or presentation of the financial statements.

- A) True
- B) False

Answer: A

Terms: Fraud in financial statement auditing

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

13) The two main categories of fraud are fraudulent financial reporting and misappropriation of assets.

A) True

B) False

Answer: A

Terms: Categories of fraud; Fraudulent financial reporting and misappropriation of assets

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

14) "Cookie jar reserves" are often created by companies whenever their earnings are high to create reserves for future periods when earnings need to be "boosted" upward.

A) True

B) False

Answer: A

Terms: Cookie jar reserves

Diff: Easy

Objective: LO 11-1

AACSB: Reflective thinking skills

15) Misappropriation of assets is normally perpetrated at the lowest levels of the organization hierarchy.

A) True

B) False

Answer: A

Terms: Misappropriation of assets

Diff: Moderate

Objective: LO 11-1

AACSB: Reflective thinking skills

16) Fraudulent financial reporting usually involves manipulation of amounts rather than disclosures.

A) True

B) False

Answer: A

Terms: Fraudulent financial reporting

Diff: Moderate

Objective: LO 11-1

AACSB: Reflective thinking skills

Learning Objective 11-2

1) Which of the following is one of the conditions for fraud described in SAS No. 99?

A)

Attitudes/rationalization	Risk Factors	Opportunities
Yes	No	Yes

B)

Attitudes/rationalization	Risk Factors	Opportunities
No	Yes	Yes

C)

Attitudes/rationalization	Risk Factors	Opportunities
Yes	No	No

D)

Attitudes/rationalization	Risk Factors	Opportunities
No	Yes	No

Answer: A

Terms: Conditions for fraud described in SAS No. 99

Diff: Easy

Objective: LO 11-2

AACSB: Reflective thinking skills

2) Financial statement manipulation risk is arguably present for all companies' financial statements. However, the risk is elevated for companies that:

- A) are heavily regulated.
- B) have foreign subsidiaries.
- C) have to make significant judgments for accounting estimates.
- D) operate in stable economic environments.

Answer: C

Terms: Financial statement manipulation risk is elevated

Diff: Easy

Objective: LO 11-2

AACSB: Reflective thinking skills

3) Which of the following is not a factor that relates to opportunities to commit fraudulent financial reporting?

- 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.

Answer: C

Terms: Factor relates to opportunities to commit fraudulent financial reporting

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

4) Fraud is more prevalent in smaller businesses and not-for-profit organizations because it is more difficult for them to maintain:

- A) adequate separation of duties.
- B) adequate compensation.
- C) adequate financial reporting standards.
- D) adequate supervisory boards.

Answer: A

Terms: Fraud more prevalent in smaller business and not-for-profit organizations

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

5) Which of the following is a factor that relates to incentives or pressures to commit fraudulent financial reporting?

- 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.

Answer: B

Terms: Factor that relates to incentives or pressures to commit fraudulent financial reporting

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

6) Which of the following is a factor that relates to attitudes or rationalization to commit fraudulent financial reporting?

- 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.

Answer: C

Terms: Factor that relates to attitudes or rationalization to commit fraudulent financial reporting

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

7) Which of the following is not a factor that relates to opportunities to misappropriate assets?

- A) Inadequate internal controls over assets.
- 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.

Answer: D

Terms: Factor that relates to opportunities to misappropriate assets

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

8) Which of the following is a factor that relates to incentives to misappropriate assets?

- A) Significant accounting estimates involving subjective judgments.
- 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.

Answer: B

Terms: Factor that relates to incentives to misappropriate assets

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

9) Which of the following does NOT represent an increased opportunity to commit fraud?

- A) Related Party Transactions
- B) the company founder is the CEO and Chairman of the Board
- C) the financial statements involve accounting estimates
- D) the company is a new audit client for the CPA firm

Answer: D

Terms: Increased opportunity to commit fraud

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

10) In the fraud triangle, fraudulent financial reporting and misappropriation of assets:

- A) share little in common.
- B) share most of the same risk factors.
- C) share the same three conditions.
- D) share most of the same conditions.

Answer: C

Terms: Fraud triangle

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

11) 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.

Terms: Conditions for fraud

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

12) 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.

Terms: Risk factors for conditions of fraud

Diff: Challenging

Objective: LO 11-2

AACSB: Reflective thinking skills

13) These two conditions are generally present when material misstatements due to fraud occur — incentives and opportunities.

A) True

B) False

Answer: A

Terms: Conditions present when material misstatements due to fraud occur

Diff: Easy

Objective: LO 11-2

AACSB: Reflective thinking skills

14) Fraud is more prevalent in large businesses than small businesses and not-for-profit organizations.

A) True

B) False

Answer: B

Terms: Fraud prevalence in organizations

Diff: Easy

Objective: LO 11-2

AACSB: Reflective thinking skills

15) The same three fraud triangle risk conditions apply to fraudulent financial reporting and misappropriation of assets.

A) True

B) False

Answer: A

Terms: Fraud triangle risk conditions

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

16) "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) True

B) False

Answer: B

Terms: Opportunities conditions included in fraud triangle

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

17) An example of a fraud risk factor describing incentives/pressures is "ineffective board of director oversight over financial reporting."

A) True

B) False

Answer: B

Terms: Fraud risk factor describing incentives/pressures

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

18) An example of a fraud risk factor describing opportunities is "ineffective board of director oversight over financial reporting."

A) True

B) False

Answer: A

Terms: Fraud risk factor describing opportunities

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

19) Auditors should consider risk factors related to incentives, opportunities, and attitudes whenever they assess the likelihood of material misstatements due to fraud.

A) True

B) False

Answer: A

Terms: Risk factors related to incentives, opportunities, and attitudes

Diff: Moderate

Objective: LO 11-2

AACSB: Reflective thinking skills

Learning Objective 11-3

1) Auditor's need to exhibit professional skepticism when auditing a client. This auditing standard is best expressed by which of the following?

- A) the auditor neither assumes dishonesty or honesty of management
- B) the auditor assumes dishonesty of management
- C) the auditor assumes honesty of management
- D) the auditor assumes management lacks integrity

Answer: A

Terms: Professional skepticism when auditing a client

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

2) SAS No. 99 requires auditors to document which of the following matters related to the auditor's consideration of material misstatements due to fraud?

- 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.

Answer: B

Terms: SAS No. 99 requires auditors to document matters related to auditor consideration of material misstatements due to fraud

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

3) As part of the brainstorming sessions, auditors are directed to emphasize:

A)

The need for professional skepticism	The audit team's response to potential fraud risks
Yes	Yes

B)

The need for professional skepticism	The audit team's response to potential fraud risks
No	No

C)

The need for professional skepticism	The audit team's response to potential fraud risks
Yes	No

D)

The need for professional skepticism	The audit team's response to potential fraud risks
No	Yes

Answer: A

Terms: Auditors directed to emphasize in brainstorming sessions

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

4) While performing their audit, the audit team uncovers fraud that is likely to have an immaterial affect on the financial statements taken as whole. In this case the auditors should:

A) plan on additional audit procedures to determine the exact amount of the fraud.

B) communicate with legal authorities as to the identity of the fraudsters.

C) disclose the fraud to the appropriate level of management or to the audit committee.

D) call the whistleblower hotline and name the suspected individuals.

Answer: C

Terms: Audit team uncovers fraud that is immaterial to financial statements

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

5) Which of the following most accurately defines professional skepticism as it is used in auditing standards?

- 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.

Answer: B

Terms: Professional skepticism and auditing standards

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

6) Which of the following is **not** a likely source of information to assess fraud risks?

- A) Communications among audit team members.
- B) Inquiries of management.
- C) Analytical procedures.
- D) Consideration of fraud risks discovered during recent audits of other clients.

Answer: D

Terms: Source of information to assess fraud risks

Diff: Challenging

Objective: LO 11-3

AACSB: Reflective thinking skills

7) 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.

Terms: Professional skepticism

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

8) 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.

Terms: Brainstorming session required by SAS No. 99

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

9) 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.

Terms: Sources of information to assess fraud risks

Diff: Challenging

Objective: LO 11-3

AACSB: Reflective thinking skills

10) Financial statements of all companies are potentially subject to manipulation.

A) True

B) False

Answer: A

Terms: Financial statements subject to manipulation

Diff: Easy

Objective: LO 11-3

AACSB: Reflective thinking skills

11) Information and idea exchange sessions by the audit team are required by SAS No. 99.

A) True

B) False

Answer: A

Terms: Information and idea exchange by audit team sessions required by SAS No. 99

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

12) SAS No. 99 does not specifically indicate which members of an audit engagement team must attend a brainstorming session.

A) True

B) False

Answer: A

Terms: SAS No. 99 and audit engagement team brainstorming session

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

13) The presence of fraud risk factors increases the likelihood of fraud and may suggest that fraud is being perpetrated.

A) True

B) False

Answer: A

Terms: Presence of fraud risk factors

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

14) Professional skepticism requires auditors to "either assume that management is dishonest or they have questionable honesty."

A) True

B) False

Answer: B

Terms: Professional skepticism

Diff: Moderate

Objective: LO 11-3

AACSB: Reflective thinking skills

Learning Objective 11-4

1) Which of the following is the best reason for management to emphasize fraud prevention and deterrence?

A) collusion and false documentation make fraud detection difficult to detect

B) collusion is impossible to detect

C) false Documentation is impossible to detect

D) all of the above are equally valid reasons

Answer: A

Terms: Reason for management to emphasize fraud prevention and deference

Diff: Moderate

Objective: LO 11-4

AACSB: Reflective thinking skills

2) Which of the following parties is responsible for implementing internal controls to minimize the likelihood of fraud?

A) External auditors

B) Audit committee members

C) Management

D) Committee of Sponsoring Organizations

Answer: C

Terms: Party responsible for implementing internal controls to minimize likelihood of fraud

Diff: Moderate

Objective: LO 11-4

AACSB: Reflective thinking skills

- 3) Research indicates that the most effective way to prevent and deter fraud is to:
- A) implement programs and controls that are based on core values embraced by the company.
 - B) hire highly ethical employees.
 - C) communicate expectations to all employees on an annual basis.
 - D) terminate employees who are suspected of committing fraud.

Answer: A

Terms: Most effective way to prevent and deter fraud

Diff: Moderate

Objective: LO 11-4

AACSB: Reflective thinking skills

- 4) Fraud awareness training should be:
- A) broad and all-encompassing.
 - 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.

Answer: C

Terms: Fraud awareness training

Diff: Moderate

Objective: LO 11-4

AACSB: Reflective thinking skills

- 5) Which party has the primary responsibility to oversee an organization's financial reporting and internal control process?
- A) the board of directors
 - B) the audit committee
 - C) management of the company
 - D) the financial statement auditors

Answer: B

Terms: Party with primary responsibility to oversee organization's financial reporting and internal control processes

Diff: Moderate

Objective: LO 11-4

AACSB: Reflective thinking skills

6) Management is responsible for:

A)

Identifying and measuring fraud risks	Taking steps to mitigate identified risks
Yes	Yes

B)

Identifying and measuring fraud risks	Taking steps to mitigate identified risks
No	No

C)

Identifying and measuring fraud risks	Taking steps to mitigate identified risks
Yes	No

D)

Identifying and measuring fraud risks	Taking steps to mitigate identified risks
No	Yes

Answer: A

Terms: Management is responsibilities with fraud risks

Diff: Moderate

Objective: LO 11-4

AACSB: Reflective thinking skills

7) The "tone at the top" provides a foundation upon which a more detailed code of conduct can be developed to provide specific guidance for the organization and its employees. Components of a code of conduct may include sections on 1) general employee conduct, 2) relationships with clients and suppliers and 3) conflicts of interest. Give a narrative description of what might be included in each of the above components of a code of conduct.

Answer: (may vary)

Employee conduct–Employees should conduct themselves in a professional manner and prohibit unprofessional behavior

Relationships with client and suppliers: Employees should avoid investing in or acquiring a financial interest in any business organization that has a contractual relationship with the organizations

Conflicts of Interest– Employees are expected to perform their duties conscientiously, honestly, and in accordance with the best interests of the organization and to not use their positions or knowledge gained for private or personal advantage

Terms: Elements for Code of Conduct

Diff: Challenging

Objective: LO 11-4

AACSB: Reflective thinking skills

Topic: Public

8) Senior management is responsible for promoting a culture of honesty and ethics. Describe what that implies for the organization.

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."

Terms: Management responsibility for promoting a culture of honesty and ethics

Diff: Challenging

Objective: LO 11-4

AACSB: Reflective thinking skills

9) Management and the board of directors are responsible for setting the "tone at the top."

A) True

B) False

Answer: A

Terms: Responsibility for setting tone at the top

Diff: Easy

Objective: LO 11-4

AACSB: Reflective thinking skills

10) The audit committee is responsible for determining an organization's financial reporting and internal control processes.

A) True

B) False

Answer: B

Terms: Responsibility for determining organization financial reporting and internal control

Diff: Moderate

Objective: LO 11-4

AACSB: Reflective thinking skills

11) The board of directors has the primary oversight responsibility to assess fraud risks and establish corporate governance programs and controls to prevent, deter, and detect fraud.

A) True

B) False

Answer: B

Terms: Primary responsibility to assess fraud risks and establish corporate governance programs

Diff: Challenging

Objective: LO 11-4

AACSB: Reflective thinking skills

12) One of the strongest internal corporate governance mechanisms over senior management is the audit committee of the board of directors.

A) True

B) False

Answer: A

Terms: Strongest internal corporate governance mechanisms

Diff: Challenging

Objective: LO 11-4

AACSB: Reflective thinking skills

Learning Objective 11-5

1) As part of designing and performing procedures to address management override of controls, auditors must perform which of the following procedures?

A)

Examine all journal entries above the level of materiality	Review accounting estimates for biases
Yes	Yes

B)

Examine all journal entries above the level of materiality	Review accounting estimates for biases
No	No

C)

Examine all journal entries above the level of materiality	Review accounting estimates for biases
Yes	No

D)

Examine all journal entries above the level of materiality	Review accounting estimates for biases
No	Yes

Answer: D

Terms: Designing and performing procedures to address override controls

Diff: Moderate

Objective: LO 11-5

AACSB: Reflective thinking skills

2) 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) preliminary assessment of control risk has been modified
- B) discrepancies in the accounting records
- C) unusual relationships between the auditor and management
- D) missing or conflicting evidence

Answer: A

Terms: Alert auditor to change initial assessment of fraud risks

Diff: Moderate

Objective: LO 11-5

AACSB: Reflective thinking skills

3) 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.

Terms: Audit procedures required to address the risk of management override of internal controls

Diff: Challenging

Objective: LO 11-5

AACSB: Reflective thinking skills

4) Because fraud perpetrators are often knowledgeable about audit procedures, SAS No. 99 requires auditors to incorporate unpredictability into the audit plan.

- A) True
- B) False

Answer: A

Terms: SAS No. 99 requires auditors to incorporate unpredictability into audit plan

Diff: Challenging

Objective: LO 11-5

AACSB: Reflective thinking skills

5) All misstatements the auditor finds during the audit should be evaluated for any indication of fraud.

- A) True
- B) False

Answer: A

Terms: All misstatements found during audit should be evaluated for indication of fraud

Diff: Challenging

Objective: LO 11-5

AACSB: Reflective thinking skills

Learning Objective 11-6

1) According to SAS No. 99, auditors are required to assume that which of the following has significant risk of fraud?

- A) overstated assets
- B) understated liabilities
- C) improper revenue recognition
- D) overstated expenses

Answer: C

Terms: SAS No. 99 requires auditors to assume significant risk of fraud

Diff: Moderate

Objective: LO 11-6

AACSB: Reflective thinking skills

2) Company management is often under pressure to increase revenue and/or net income. One approach is to use a "bill and hold" arrangement. This is an example of which of the following?

- A) adjustments to revenue accounts
- B) fictitious revenue recorded
- C) premature revenue recognized
- D) alteration of cutoff documents

Answer: C

Terms: Bill and hold arrangement to increase revenue and/or net income

Diff: Moderate

Objective: LO 11-6

AACSB: Reflective thinking skills

3) A company is concerned with the theft of cash after the sale has been recorded. One way in which fraudsters conceal the theft is by a process called "lapping". Which of the following best describes lapping?

- A) reduce the customer's account by recording a sales return
- B) write off the customer's account
- C) apply the payment from another customer to the customer's account
- D) reduce the customer's account by recording a sales allowance

Answer: C

Terms: Lapping; Theft of cash

Diff: Challenging

Objective: LO 11-6

AACSB: Reflective thinking skills

4) Analytical procedures can be very effective in detecting inventory fraud. Which of the following analytical procedures would NOT be useful in detecting fraud?

- A) Gross margin percentage
- B) Inventory Turnover
- C) Cost of sales percentage
- D) Accounts payable turnover

Answer: D

Terms: Analytical procedures to detect inventory fraud

Diff: Challenging

Objective: LO 11-6

AACSB: Reflective thinking skills

5) What are the three main types of revenue manipulations employed to commit fraudulent financial reporting and give an example for each type?

Answer: The three main types of revenue manipulation are:

- Fictitious revenues—preparation of fictitious documentary evidence for sales and reduction of inventory
- Premature revenue recognition, and—bill and hold; side agreements; unlimited right of return
- Manipulation of adjustments to revenues - adjustments to the sales and returns allowance account; i.e. not recording returns

Terms: Types of revenue manipulation

Diff: Moderate

Objective: LO 11-6

AACSB: Reflective thinking skills

6) You are conducting an audit and you are concerned about revenue recognition issues because of timing concerns due to proper cutoff and channel stuffing (sales to distributors above "normal" business needs. Describe at **least two** audit procedures that would best address your concerns?

Answer: Review sales journal for unusual activity near year end

Review the contractual terms of sales regarding rights of return

Review historical evidence of distributor shipments

Review sales invoices and shipping documents for two weeks after year end

Terms: Audit procedures concerning revenue recognition issues

Diff: Challenging

Objective: LO 11-6

AACSB: Reflective thinking skills

7) The most common fraud in the acquisition and payment cycle is for the fraudster to issue payments to fictitious vendors and deposit the cash in fictitious accounts. What procedures could the company take to prevent this type of fraud?

Answer: Only payments to approved vendors

Detailed review of legitimacy of approved vendors

Careful review of document authorizing the acquisition

Segregation duties between authorizing payments and authorizing the acquisition

Cancelling supporting documents to prevent their use as support for multiple payments

Terms: Procedures to prevent fraud in the acquisition and payment cycle

Diff: Challenging

Objective: LO 11-6

AACSB: Reflective thinking skills

Learning Objective 11-7

1) The audit team has identified and documented fraud risk. Their next step should be to:

- A) evaluate factors that should reduce risk.
- B) develop programs to test for fraud.
- C) proceed with performing tests of controls.
- D) proceed with performing substantive tests of balances.

Answer: D

Terms: Identified and documented fraud risk

Diff: Moderate

Objective: LO 11-7

AACSB: Reflective thinking skills

2) Which of the following is least likely to uncover fraud?

- A) External auditors
- B) Internal auditors
- C) Internal controls
- D) Management

Answer: A

Terms: Least likely to uncover of fraud risks

Diff: Moderate

Objective: LO 11-7

AACSB: Reflective thinking skills

3) Which of the following is not a category of inquiry used by auditors?

- A) Assessment inquiry
- B) Declarative inquiry
- C) Interrogative inquiry
- D) Informational inquiry

Answer: B

Terms: Category of inquiry used by auditors

Diff: Challenging

Objective: LO 11-7

AACSB: Reflective thinking skills

4) _____ inquiry is used when the auditor seeks responses from the interviewee about his or her knowledge of an event or circumstance.

- A) Assessment
- B) Declarative
- C) Interrogative
- D) Informational

Answer: C

Terms: Inquiry used when auditor seeks responses

Diff: Challenging

Objective: LO 11-7

AACSB: Analytic skills

5) _____ inquiry is used to ascertain whether information already obtained is correct, factual or truthful.

- A) Assessment
- B) Declarative
- C) Interrogative
- D) Informational

Answer: A

Terms: Inquiry used to ascertain whether information already obtained is correct

Diff: Challenging

Objective: LO 11-7

AACSB: Reflective thinking skills

6) When the auditor suspects that fraud may be present, SAS No. 99 requires the auditor to:

- A) terminate the engagement with sufficient notice given to the client.
- 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.

Answer: C

Terms: SAS No. 99 requires auditor to do when fraud is suspected

Diff: Challenging

Objective: LO 11-7

AACSB: Reflective thinking skills

7) 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?

- A) PCAOB
- B) audit committee
- C) an appropriate level of management that is at least one level above those involved
- D) the internal auditors

Answer: B

Terms: Auditor communicate with whom when senior management fraud may be present

Diff: Challenging

Objective: LO 11-7

AACSB: Reflective thinking skills

8) 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.

Terms: Inquiry techniques

Diff: Challenging

Objective: LO 11-7

AACSB: Reflective thinking skills

9) PCAOB Standard 5 indicates that material fraud by senior management is a material weakness.

A) True

B) False

Answer: A

Terms: Senior management fraud

Diff: Moderate

Objective: LO 11-7

AACSB: Reflective thinking skills

Topic: Public

10) Auditors must issue a qualified opinion on internal control whenever senior management commits fraud that is considered a material weakness.

A) True

B) False

Answer: B

Terms: Opinion issued on internal control with senior management fraud

Diff: Challenging

Objective: LO 11-7

AACSB: Reflective thinking skills

Topic: Public