Auditing and Assurance Services, 16e **(Arens/Elder/Beasley)**
Chapter 24 Completing the Audit

24.1 Learning Objective 24-1

1) Auditors often integrate procedures for presentation and disclosure objectives with
A)

Tests for transaction-related objectives	Tests for balance-related objectives
Yes	Yes

B)

Tests for transaction-related objectives	Tests for balance-related objectives
No	No

C)

Tests for transaction-related objectives	Tests for balance-related objectives
Yes	No

D)

Tests for transaction-related objectives	Tests for balance-related objectives
No	Yes

Answer: A
Terms: Procedures for presentation and disclosure objectives
Diff: Easy
Objective: LO 24-1
AACSB: Reflective thinking

2) The auditor's primary concern relative to presentation and disclosure-related objectives is
A) accuracy.
B) existence.
C) completeness.
D) occurrence.
Answer: C
Terms: Presentation and disclosure-related objectives
Diff: Easy
Objective: LO 24-1
AACSB: Reflective thinking

3) An auditor is reconciling the amounts included in the long-term debt footnotes to the information examined and supported in the audit files for long-term debt. Which audit objective is being satisfied?
A) accuracy and valuation
B) occurrence and rights and obligations
C) completeness
D) classification and understandability
Answer: A
Terms: Presentation and disclosure-related objectives
Diff: Moderate
Objective: LO 24-1
AACSB: Reflective thinking

4) Which of the following is an accurate statement regarding presentation and disclosure?
A) Auditors generally set the risk as low that all required information may not be completely disclosed in the footnotes.
B) Audit tests performed in earlier audit phases provides sufficient appropriate evidence about contingent liabilities and subsequent events.
C) Auditors do not conduct tests of controls related to disclosures when the initial assessment of control risk is below maximum.
D) In phase IV (completing the audit), auditors evaluate whether the overall presentation of the financial statements and related footnotes complies with accounting standards.
Answer: D
Terms: Presentation and disclosure-related audit objective performed in what phase of audit process
Diff: Moderate
Objective: LO 24-1
AACSB: Reflective thinking

5) When an auditor reviews the financial statements to determine if assets are properly classified between current and noncurrent, he is satisfying the audit objective of occurrence and rights and obligations.
Answer: FALSE
Terms: Presentation and disclosure-related objectives
Diff: Moderate
Objective: LO 24-1
AACSB: Reflective thinking

24.2 Learning Objective 24-2

1) If a potential loss on a contingent liability is remote, the liability usually is
A) disclosed in footnotes, but not accrued.
B) neither accrued nor disclosed in footnotes.
C) accrued and indicated in the body of the financial statements.
D) disclosed in the auditor's report but not disclosed on the financial statements.
Answer: B
Terms: Contingent liability; remote
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

2) A commitment is best described as
A) an agreement to commit the firm to a set of fixed conditions in the future.
B) an agreement to commit the firm to a set of fixed conditions in the future that depends on company profitability.
C) an agreement to commit the firm to a set of fixed conditions in the future that depends on current market conditions.
D) a potential future obligation to an outside party for an as yet to be determined amount.
Answer: A
Terms: Commitments
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

3) Which of the following groups has the responsibility for identifying and deciding the appropriate accounting treatment for recording or disclosing contingent liabilities?
A) auditors
B) legal counsel
C) management
D) management and the auditors
Answer: C
Terms: Recording or disclosing contingent liabilities
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

4) You are auditing Rodgers and Company. You are aware of a potential loss due to noncompliance with environmental regulations. Management has assessed that there is a 40% chance that a $10M payment could result from the non-compliance. The appropriate financial statement treatment is to
A) accrue a $4 million liability.
B) disclose a liability and provide a range of outcomes.
C) since there is less than a 50% chance of occurrence, ignore.
D) since there is greater that a remote chance of occurrence, accrue the $10 million.
Answer: B
Terms: Potential loss for noncompliance
Diff: Moderate
Objective: LO 24-2
AACSB: Analytic thinking

5) Which of the following is a contingent liability with which an auditor is particularly concerned?
A)

Notes receivable discounted	Product warranties
Yes	Yes

B)

Notes receivable discounted	Product warranties
No	No

C)

Notes receivable discounted	Product warranties
Yes	No

D)

Notes receivable discounted	Product warranties
No	Yes

Answer: A
Terms: Contingent liability; auditor particularly concerned
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

6) Audit procedures related to contingent liabilities are initially focused on
A) accuracy.
B) completeness.
C) existence.
D) occurrence.
Answer: D
Terms: Audit procedures related to contingent liabilities
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

7) With which of the following client personnel would it generally **not** be appropriate to inquire about commitments or contingent liabilities?
A) controller
B) president
C) accounts receivable clerk
D) vice president of sales
Answer: C
Terms: Inquire for commitments or contingent liabilities
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

8) Inquiries of management regarding the possibility of unrecorded contingencies will be useful in uncovering

A)

Management's intentional failure to disclose existing contingencies.	When management does not comprehend accounting disclosure requirements.
Yes	Yes

B)

Management's intentional failure to disclose existing contingencies.	When management does not comprehend accounting disclosure requirements.
No	No

C)

Management's intentional failure to disclose existing contingencies.	When management does not comprehend accounting disclosure requirements.
Yes	No

D)

Management's intentional failure to disclose existing contingencies.	When management does not comprehend accounting disclosure requirements.
No	Yes

Answer: D
Terms: Inquiries of management; Unrecorded contingencies
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

9) Which of the following is **not** considered a commitment?
A) agreements to purchase raw materials
B) pension plans
C) agreements to lease facilities at set prices
D) Each of the above is a commitment.
Answer: D
Terms: Commitments
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

10) If an auditor concludes there are contingent liabilities, then he or she must evaluate the
A)

Materiality of the potential liability.	Nature of the disclosure to be included in the financial statements.
Yes	Yes

B)

Materiality of the potential liability.	Nature of the disclosure to be included in the financial statements.
No	No

C)

Materiality of the potential liability.	Nature of the disclosure to be included in the financial statements.
Yes	No

D)

Materiality of the potential liability.	Nature of the disclosure to be included in the financial statements.
No	Yes

Answer: A
Terms: Contingent liabilities
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

11) One of the primary approaches in dealing with uncertainties in loss contingencies uses a(n) _____ threshold.
A) monetary
B) materiality
C) probability
D) analytical
Answer: C
Terms: Contingent liabilities
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

12) If the auditor concludes that there are contingent liabilities, he or she must evaluate the significance of the potential liability and the nature of the disclosure needed in the financial statements. Which of the following statements is **not** true?
A) The potential liability is sufficiently well known in some instances to be included in the financial statements as an actual liability.
B) Disclosure may be unnecessary if the contingency is highly remote or immaterial.
C) A CPA firm often obtains a separate evaluation of the potential liability from its own legal counsel rather than relying on management or management's attorneys.
D) The client's attorneys must remain independent when evaluating the likelihood of losing the lawsuit.
Answer: D
Terms: Contingent liabilities; significance of potential liability; nature of disclosure
Diff: Challenging
Objective: LO 24-2
AACSB: Reflective thinking

13) When using the probability threshold for contingencies, the likelihood of the occurrence of the event is classified as
A) not likely, likely, or highly likely.
B) remote, reasonably possible, or probable.
C) slight, moderate, great.
D) remote, likely, possible.
Answer: B
Terms: Contingent liabilities
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

14) When dealing with contingencies,
A) all contingencies must be disclosed or footnoted.
B) the auditor must exercise considerable professional judgment when evaluating whether the client has applied the appropriate treatment.
C) it is easy for the auditor to uncover contingencies without management's cooperation.
D) the review for contingent liabilities is only performed at the beginning and the end of the audit.
Answer: B
Terms: Contingent liabilities
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

15) Which of the following is **not** a common audit procedure used to search for contingent liabilities?
A) examine letters of credit
B) examine payroll reports
C) review internal revenue agent reports
D) analyze legal expense
Answer: B
Terms: Contingent liabilities
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

16) Contingent liability disclosure in the footnotes of the financial statements would normally be made when
A) the outcome of the accounting event is deemed probable, but a reasonable estimation as to the amount cannot be made by the client or auditor.
B) a reasonable estimation of the loss can be made, but the outcome is not probable.
C) the outcome of the accounting event is deemed probable, and a reasonable estimation as to the amount can be made.
D) the outcome of the accounting event as well as a reasonable estimation of the loss cannot be made.
Answer: A
Terms: Contingent liability disclosure
Diff: Challenging
Objective: LO 24-2
AACSB: Reflective thinking

17) Three conditions are required for a contingent liability to exist. Which of the following is **not** one of those conditions?
A) There is a potential future payment to an outside party or the impairment of an asset that resulted from an existing condition.
B) The outcome must be resolved by a third-party.
C) There is uncertainty about the amount of the future payment or impairment.
D) The outcome will be resolved by some future event or events.
Answer: B
Terms: Contingent liabilities
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

18) Distinguish between contingent liabilities and commitments.
Answer: Contingent liabilities are potential future obligations to an outside party for an unknown amount resulting from activities that have already taken place. Commitments are agreements that an entity will hold to a fixed set of conditions in the future regardless of what happens to profits or the economy as a whole.
Terms: Contingent liabilities; commitments
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

19) Define the term contingent liability and discuss the criteria accountants and auditors use to classify these accounting events.
Answer: A contingent liability is a potential future obligation to an outside party for an unknown amount resulting from activities that have already taken place. Three conditions are required for a contingent liability to exist: (1) there is a potential future payment to an outside party or the impairment of an asset that resulted from an existing condition; (2) there is uncertainty about the amount for the future payment or impairment; and (3) the outcome will be resolved by some future event or events. Accounting standards describe three levels of likelihood of occurrence and the appropriate financial statement treatment for each likelihood as follows:

a. Probable—future event likely to occur and amount can be reasonably estimated then the financial statement accounts are adjusted. If amount cannot be reasonably estimated, then a footnote disclosure is necessary.

b. Reasonably possible—chance of occurring is more than remote, but less than probable. Footnote disclosure is necessary.

c. Remote—chance of occurrence is slight, no disclosure is necessary.
Terms: Contingent liabilities
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

20) With what types of contingencies might an auditor be concerned?
Answer: The auditor is generally concerned with contingencies arising from:
1. pending litigation for patent infringement, product liability or other actions
2. income tax disputes
3. product warranties
4. notes receivable discounted
5. guarantees of obligations of others
6. unused balances of outstanding letters of credit
Terms: Types of contingencies
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

21) What are the three required conditions for a contingent liability to exist?
Answer:
1. There is potential for future payment to an outside party or the impairment of an asset that resulted from an existing condition.
2. There is uncertainty about the amount of the future payment or impairment.
3. The outcome will be resolved by some future event or events.
Terms: Conditions for contingent liability to exist
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

22) An environmental clean-up lawsuit is pending against your client. What information about the lawsuit would you as the auditor need in order to determine the proper accounting treatment?
Answer: The first step is to determine if a contingency exists. Three conditions are required for a contingent liability to exist: (1) there is a potential future payment to an outside party or the impairment of an asset that resulted from an existing condition; (2) there is uncertainty about the amount for the future payment or impairment; and (3) the outcome will be resolved by some future event or events.

Since the lawsuit meets the criteria for a contingent liability, the next step is to evaluate the significance of the potential liability and the nature of the disclosure needed in the financial statements to obtain evidence about the occurrence and right and obligations presentation and disclosure objective. Accounting standards describe three levels of likelihood of occurrence and the appropriate financial statement treatment for each likelihood as follows:
a. Probable—future event likely to occur and amount can be reasonably estimated then the financial statement accounts are adjusted. If amount cannot be reasonably estimated, then a footnote disclosure is necessary.

b. Reasonably possible—chance of occurring is more than remote, but less than probable. Footnote disclosure is necessary.

c. Remote—chance of occurrence is slight. No disclosure is necessary.
Terms: Correct accounting for lawsuit
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

23) Discuss three audit procedures commonly used to search for contingent liabilities.
Answer:
- Inquire of management (orally and in writing) about the possibility of unrecorded contingencies.
- Review current and previous years' internal revenue agent reports for income tax settlements.
- Review the minutes of directors' and stockholders' meetings for indications of lawsuits or other contingencies.
- Analyze legal expense for the period under audit, and review invoices and statements from legal counsel for indications of contingent liabilities.
- Obtain a letter from each major attorney performing legal services for the client as to the status of pending litigation or other contingent liabilities.
- Review audit documentation for any information that may indicate a potential contingency.
- Examine letters of credit in force as of the balance sheet date and obtain a confirmation of the used and unused balances.

Terms: Audit procedures for search of contingent liabilities
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

24) A lawsuit has been filed against your client. If, in the opinion of legal counsel, the likelihood your client will lose the lawsuit is remote, no financial statement accrual or disclosure of the potential loss would generally be required.
Answer: TRUE
Terms: Lawsuit is remote; financial statement accrual or disclosure
Diff: Easy
Objective: LO 24-2
AACSB: Reflective thinking

25) Current professional auditing standards make it clear that management, not the auditor, is responsible for identifying and deciding the appropriate accounting treatment for contingent liabilities.
Answer: TRUE
Terms: Auditing standards; Contingent liabilities
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

26) Many of the audit procedures for finding contingencies are usually performed as an integral part of various segments of the audit rather than as a separate activity near the end of the audit.
Answer: TRUE
Terms: Existence of contingent liabilities
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

27) The probability threshold for dealing with uncertainty in loss contingencies uses the terms likely and unlikely.
Answer: FALSE
Terms: Contingent liabilities
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

28) The first stop in the audit of contingencies is to determine the amount of the contingency.
Answer: FALSE
Terms: Contingent liabilities
Diff: Moderate
Objective: LO 24-2
AACSB: Reflective thinking

24.3 Learning Objective 24-3

1) Auditors will generally send a standard inquiry to the client's attorney letter to
A) only those attorneys who have devoted substantial time to client matters during the year.
B) every attorney that the client has been involved with in the current or preceding year, plus any attorney the client engages on occasion.
C) every attorney whose legal fees for the year exceed a materiality threshold.
D) only the attorney who represents the client in proceeding where the client is defendant.
Answer: B
Terms: Standard inquiry to the client's attorney letter
Diff: Easy
Objective: LO 24-3
AACSB: Reflective thinking

2) What needs to be included in a standard inquiry to the client's attorney letter sent to a client's legal counsel?

A)

Any pending threatened litigation with which the attorney has had significant involvement	The amount of legal fees paid by the client to the attorney
Yes	Yes

B)

Any pending threatened litigation with which the attorney has had significant involvement	The amount of legal fees paid by the client to the attorney
No	No

C)

Any pending threatened litigation with which the attorney has had significant involvement	The amount of legal fees paid by the client to the attorney
Yes	No

D)

Any pending threatened litigation with which the attorney has had significant involvement	The amount of legal fees paid by the client to the attorney
No	Yes

Answer: C
Terms: Standard inquiry to the client's attorney letter
Diff: Easy
Objective: LO 24-3
AACSB: Reflective thinking

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