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QUESTION 1

Don Wolf became a general partner in ABC Associates on January 1, 1989, with a 5% interest in ABC's profits, losses, and capital. ABC is a distributor of auto parts. Wolf does not materially participate in the partnership business. For the year ended December 31, 1989, ABC had an operating loss of \$100,000. In addition, ABC earned interest of \$20,000 on a temporary investment. ABC has kept the principal temporarily invested while awaiting delivery of equipment that is presently on order. The principal will be used to pay for this equipment. Wolf's passive loss for 1989 is:

- A. \$0
- B. \$4,000
- C. \$5,000
- D. \$6,000

Correct Answer: C

Explanation:

Choice "c" is correct. Wolf's passive loss for 1989 is \$5,000 (\$100,000 operating loss × 5% interest in partnership).

Choice "a" is incorrect. Wolf did not materially participate in the partnership, so the loss was passive.

Choice "b" is incorrect. Wolf's passive loss of \$5,000 could not be reduced by his distributive share of the partnership's "interest income" totaling \$1,000. Interest income is considered "portfolio income," and neither the partnership nor a partner can offset it against passive losses.

Choice "d" is incorrect. No items of income or deduction from portfolio income or activities in which the taxpayer materially participates may be combined or offset with passive losses unless the activity generating the loss is completely disposed of in a taxable transaction.

QUESTION 2

Symbol B most likely represents:

- A. Customer orders.
- B. Receiving reports.
- C. Customer checks.
- D. Sales invoices.

Correct Answer: D

Explanation:

Choice "d" is correct. The two documents most likely to be generated by the revenue cycle application are credit memos (already identified in the flowchart) and sales invoices.

Choice "a" is incorrect. Customer orders are input at the beginning of the process, as noted in the flowchart. Customer orders are not generated by the company's revenue cycle.

Choice "b" is incorrect. Receiving reports are part of the inventory/purchasing/cash disbursements cycle.

Choice "c" is incorrect. Customer checks and remittances are entered into the application at the top of the flowchart. Customer checks are not an output of the revenue cycle.

QUESTION 3

In assessing the objectivity of internal auditors, an independent auditor should:

- A. Evaluate the quality control program in effect for the internal auditors.
- B. Examine documentary evidence of the work performed by the internal auditors.
- C. Test a sample of the transactions and balances that the internal auditors examined.
- D. Determine the organizational level to which the internal auditors report.

Correct Answer: D

Explanation: Choice "d" is correct. When assessing the internal auditors' objectivity, the auditor should obtain information about whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors. Choice "a" is incorrect. A quality control program would impact the competence of the internal audit staff, not their objectivity. Choice "b" is incorrect. Examining documentary evidence produced by the internal auditors would help the auditor evaluate the quality and effectiveness of the internal auditors' work, but would not help assess objectivity. Choice "c" is incorrect. Testing a sample of transactions and balances examined by the internal auditors would help the auditor evaluate the quality and effectiveness of the internal auditors' work, but would not help assess objectivity.

QUESTION 4

Before accepting an engagement to audit a new client, a CPA is required to obtain:

- A. An understanding of the prospective client's industry and business.
- B. The prospective client's signature to the representation letter.
- C. A preliminary understanding of the prospective client's control environment.
- D. The prospective client's consent to make inquiries of the predecessor auditor, if any.

Correct Answer: D

Explanation:

Choice "d" is correct. Inquiry of the predecessor auditor is a required pre-acceptance procedure.

However, consent of the prospective client must be obtained before a CPA can make such inquiries of the predecessor auditor.

Choice "a" is incorrect. Obtaining an understanding of the client's industry and business is a planning procedure performed after an engagement is accepted.

Choice "b" is incorrect. A management representation letter is not obtained until the end of the audit.

Choice "c" is incorrect. Obtaining a preliminary understanding of the client's control environment is an audit procedure (required by the second standard of fieldwork) that would be performed after an engagement is accepted.

QUESTION 5

An audit supervisor reviewed the work performed by the staff to determine if the audit was adequately performed. The supervisor accomplished this by primarily reviewing which of the following?

- A. Checklists.
- B. Working papers.
- C. Analytical procedures.
- D. Financial statements.

Correct Answer: B

Explanation: Choice "b" is correct. Audit documentation, or working papers, comprises the principal record of audit procedures performed, evidence obtained, and conclusions reached. Reviewing the working papers allows a supervisor to understand the work performed and the evidence obtained, and to evaluate whether the audit was adequately performed. Choice "a" is incorrect. Checklists might be used within the audit documentation, but checklists alone would not provide a comprehensive record of the audit procedures performed, the evidence obtained, and conclusions reached. Choice "c" is incorrect. Analytical procedures might be documented within the working papers, but such procedures alone would not provide a comprehensive record of the audit procedures performed, the evidence obtained, and conclusions reached. Choice "d" is incorrect. Reviewing the financial statements would provide no information regarding the audit procedures performed, the evidence obtained, or conclusions reached, and therefore would provide no basis on which to review the work performed by the staff.