Question 1 of 29

Section 404 of the Sarbanes-Oxley Act of 2002 requires each annual report of an issuer to include which of the following?

A. Representations from the company's external auditors that the company has effective internal control over operations.

B. Management representations that the company's external auditors have examined its internal control over compliance with laws and regulations.

C. Reasonable assurances that fraud will be identified before the issuance of the company's annual report.

D. **Management's assessment of the effectiveness of internal control over financial reporting.** ✓

Explanation:

SOX: responsibilities regarding internal control of issuers	
Management	• Acknowledge responsibility for internal control • Assess effectiveness of internal control
Auditors	• Understand client's control structure • Assess risk of material weakness • Evaluate and opine on design and operating effectiveness of controls

The Sarbanes-Oxley Act of 2002 (SOX) imposes wide-ranging and stringent requirements on issuers and their auditors. Some of those requirements are aimed at increasing the reliability of internal control over financial reporting.

Management is responsible for instituting, documenting, and maintaining effective internal control over financial reporting. SOX further requires **issuers** to include in their annual report (10-K) **management's assessment** of the effectiveness of **internal control** and a statement that management is responsible for that internal control. Auditors are required to report on management's assessment of internal control.

(Choice A) Internal control over operations includes processes designed to improve the efficiency of day-to-day operations, not just the quality of financial reporting. Auditors of public companies are required to report on the effectiveness of internal control over *financial reporting*, not operations. In addition, it is management, not the auditor, that makes *representations* on internal control.

(Choice B) An issuer's management is required to affirm that their external auditor has issued a report on the effectiveness of control over *financial reporting*, not control over compliance with laws and regulations.

(Choice C) An auditor obtains reasonable assurance that the financial statements are free from *material* misstatement, whether due to fraud or error. No one can provide

reasonable assurance that *all* fraud will be or has been detected.

Things to remember:
An issuer's management must assess the effectiveness of internal control over financial reporting and affirm their responsibility for internal control in the annual report. Auditors attest to and report on management's assessment.

Question 2 of 29

Which of the following situations most clearly illustrates a breach of fiduciary duty by one or more members of the board of directors of a corporation?

A. A corporation previously has distributed 50% of its earnings as dividends. This year, it has annual earnings per share of $2, and the board of directors voted 4 to 1 against paying any dividend to finance growth.

B. A director of a corporation negotiated the purchase of a computer system on behalf of the corporation. The director co-owns the computer vendor, which he disclosed to the other board members. The purchase price was competitive, and the board (absent the vendor co-owner) unanimously approved the purchase.

C. A director who has been on the board for five years has not attended a total of three meetings. A key vote was held at one of the missed meetings which resulted in a tie due to his absence.

D. A director learned that the corporation was thinking of buying retail space. The director then purchased a vacant building in the same city that could have been suitable for use by the corporation. ✓

Explanation:

Board of directors fiduciary duties

Duty of loyalty: act in entity's best interest, avoid conflict of interest

Duty of care: act objectively; exercise independent, informed judgment; promote success

Duty of diligence: use reasonable care when entering into agreements or transactions with another party

The **board of directors (BOD)** is elected by and answers to the entity's shareholders. It is the corporation's governing body and gets its responsibilities and authority from the entity's bylaws (ie, internal rules of the corporation). Directors must act in good faith, be loyal to the entity, and exercise due care and diligence in all their board functions.

A director's **fiduciary duty** requires that the director not put personal interest above the corporation's interest. By purchasing the vacant building, the director failed to give the corporation first refusal on an opportunity relating to its business, thereby breaching the director's duty of loyalty.

(Choice A) The BOD has no obligation to declare dividends, providing their decision was based on objective information and what was in the entity's best interest.

(Choice B) A director may not engage in self-dealing unless abstaining from voting on the issue and informing the other directors of the conflict. Because these conditions were met, there is no breach of fiduciary duty.

(Choice C) Absence from a BOD meeting is not necessarily a breach of duty. Had there been an *excessive* number of unexcused absences, a case could be made for a breach

of responsibilities.

Things to remember:
A board of directors' fiduciary duty requires that each director put the corporation's interest above personal interest. By purchasing the building, the director failed to give the corporation first refusal on an opportunity relating to its business, thereby breaching the director's duty of loyalty.

Question 3 of 29

A registered public accounting firm is conducting an audit of an issuer and initiated its current-year audit on January 1, Year 3. Many of the firm's former auditors are now employed by the client. Under which of the following circumstances may the firm perform the audit?

A. The client's CFO was the lead partner on the audit until December 31, Year 1. ✓

B. The client's CEO was a manager on the audit until June 30, Year 2.

C. The client's controller was a staff accountant on the audit for two weeks during Year 2.

D. The client's chief accounting officer was the concurring partner on the audit until April 15, Year 2.

Explanation:

Independence requirements of Sarbanes-Oxley for audits of issuers

• Auditor must cool off for one year before taking key role with client
• Auditor cannot perform most nonaudit services for audit clients
• Auditor must report to audit committee:
  ○ Critical accounting policies and practices
  ○ Alternative accounting discussed with management
  ○ Material written communication between auditor and management
• Audit partner and reviewing partner must rotate off engagement every five years
• Audit committee must preapprove nonaudit services provided

The Sarbanes-Oxley Act (SOX) was enacted in response to numerous accounting scandals at public companies. It imposes wide-ranging and stringent requirements on issuers and their auditors, including several requirements (Title II) related to independence.

SOX prohibits an accounting firm from **auditing** an issuer if anyone in a financial reporting oversight role (eg, **CFO**) for the client was employed by the firm and participated in an audit of the client during the **year preceding** the current audit. This requirement prevents the former member of the audit team from having an undue influence on the performance of the audit. It also mitigates the potential threat of excess familiarity between the auditor and client.

(Choices B, C, and D) Because the CEO, controller, and chief accounting officer are all in financial reporting oversight roles and each participated in the client's audit in the past year, the firm's independence would be impaired.

Things to remember:
The Sarbanes-Oxley Act expanded the independence requirements for auditors of public companies in several ways. One key restriction prevents firms from performing audits

for issuers if anyone in a financial reporting oversight role with the client worked for the firm on the client's audit within one year preceding the engagement.

Question 4 of 29

According to the SEC, which of the following best describes a nonaudit service that, when jointly provided with the audit of an issuer, would result in the accountant's loss of independence?

A. Preparing the client's tax returns based on information prepared by management.

B. Providing a comfort letter in regard to the client's meeting the debt covenant requirements.

C. Issuing a report on management's assessment of the client's internal controls.

D. **Preparing the client's footnote disclosure of significant accounting policies.** ✓

Explanation:

SOX Title II: Prohibited nonaudit services for issuer audit clients

Self-review threat	• Services related to accounting records (eg, bookkeeping) • Information system design or implementation • Appraisal/valuation services • Actuarial services
Perceived as conflict	• Internal audit outsourcing services • Management or human resources functions • Broker dealer investment advisor or banking services • Legal services and expert services that are **unrelated** to audit
Others	• Any other services the SOX board determines impermissible

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If an accounting firm performs both audit and nonaudit services for the same client, potential threats to the auditing firm's independence may arise. To prevent such threats, the **SEC prohibits many nonaudit services** from being performed for issuer audit clients. Auditors are permitted to perform certain other nonaudit services, provided they are preapproved by the client's audit committee.

Auditors are engaged to provide an independent opinion on the fairness of the client's financial statements, **including** the footnote disclosures. If the auditors **prepared** those **disclosures**, they would be providing an opinion on their own work, creating a self-review threat that would impair their independence.

(Choice A) Tax services are generally permitted for audit clients because they do not create an alignment or conflict of interests between auditor and client.

(Choice B) Auditors routinely provide comfort letters to underwriters of audit clients' securities and are likely the only parties underwriters would trust to do so.

(Choice C) Because issuers are required to have integrated audits, auditors are not only able to but must report on management's assessment of internal control.

Things to remember:
Auditors are prohibited from performing many nonaudit services for issuer audit clients, including the preparation of financial statements or elements of financial statements (eg, footnote disclosures). However, certain nonaudit services (eg, tax preparation) can generally be performed with preapproval from the issuer's audit committee.

Question 5 of 29

A person identified as an audit committee financial expert of an issuer generally must have acquired the attributes of a financial expert through any of the following experiences, **except**

A. As a principal financial officer, principal accounting officer, controller, public accountant, or auditor.

B. Serving on at least one other issuer's audit committee or disclosure committee of the board of directors. ✓

C. Actively supervising a principal financial officer or principal accounting officer.

D. Assessing the performance of public accountants with respect to preparation, auditing, or evaluation of financial statements.

Explanation:

Audit committee functions

- Oversee financial reporting process
- Ensure financial information is reliable and available to stakeholders
- Present annual audit to board
- Recommend external auditors
- Oversee audit and control systems

Board of directors (BOD) members serve on functional committees such as the audit committee (A/C) to disburse the board's responsibilities. The Sarbanes-Oxley Act requires that the A/C consist of **independent members** of the BOD. Independent members are not employed by the entity, are not shareholders, and have no financial relationship with the entity.

One member of the A/C must be a financial expert. Financial experts do not need to be CPAs; however, they must have (among other things) an understanding of the functions of the A/C and internal controls; an understanding of GAAP along with the ability to assess the application of GAAP to accounting estimates, accruals, and reserves; and experience auditing, preparing, analyzing, or evaluating comparable financial statements (F/S).

These requirements can be gained through experience:

- as a principal financial or accounting officer, controller, public accountant, or auditor **(Choice A)**.
- in actively supervising any of the above positions **(Choice C)**.
- in overseeing or assessing companies or public accountants in the preparation, auditing, or evaluation of F/S **(Choice D)**.

Serving on an audit committee or disclosure committee of the BOD *does not provide* an individual with the *expertise* necessary to serve as financial expert of an issuer. More in-depth experience, such as working as a controller, is required.

Things to remember:
The board of directors audit committee's financial expert must understand GAAP and financial statements and has worked as a principal financial or accounting officer, controller, or public accountant.

Question 6 of 29

During an audit of the financial statements of a company, the CFO provides a spreadsheet to the audit team that contains a number of errors that are material to the financial statements. Under what circumstances, would this situation be a violation of the rules of the Sarbanes-Oxley Act of 2002 on improper influence on the conduct of audits?

A. The CFO discovers and corrects most of the errors in the spreadsheet, which was prepared by a staff accountant. One immaterial error remains of which the CFO is aware, and this error remains undetected by the audit team, but the financial statements end up being fairly presented.

B. The audit team discovers the errors through alternate procedures when they discern that the spreadsheet was improperly manipulated by the CFO. This intentional conduct of the CFO does not succeed in affecting the audit. ✓

C. The CFO had the spreadsheet prepared by a vendor of the company; the vendor intentionally misstates information in the spreadsheet, and the CFO does **not** discover the misstatements. The errors remain undetected by the audit team, and the financial statements are materially misleading.

D. The CFO was unaware of the errors in the spreadsheet, which was prepared by a staff accountant and reviewed by the CFO. The errors remain undetected by the audit team, and the financial statements are materially misleading.

Explanation:

Sarbanes-Oxley (SOX) corporate responsibility requirements for issuers
• Independent audit committee hires, compensates, and communicates with auditor • CEO and CFO certify that financial statements are fairly presented • CEO and CFO take responsibility for internal controls and disclose deficiencies • Officer/director prohibited from materially misleading auditor (eg, fraud) • If earnings are restated, executive bonuses can be clawed back (ie, taken back) • SEC may bar violators of securities laws from serving as officer/director

The issuance of anything but an unmodified (or unqualified) opinion by an auditor can have a very strong negative effect on a company's share price. Because the compensation of officers and directors is often tied to share price, they may be motivated to mislead auditors.

To counteract this motivation, the Sarbanes-Oxley Act (SOX) **prohibits officers** and directors of **issuers** from **misleading** or fraudulently influencing **auditors** if it would result in a **material misstatement** to the financial statements. The rule applies when there is actual intent to deceive the auditor (ie, fraud) or when the officer/director should have known or detected the error (ie, gross negligence).

Note: When auditors encounter fraud by senior management, regardless of the amount, they must report it to the audit committee and reevaluate the risk of material misstatement due to fraud.

(Choice A) Because the CFO had no intent to deceive, there was no fraud in this case. Although the CFO knew of the error, there was still no violation of SOX because the effect was *immaterial*.

(Choices C and D) Although there were material errors in these cases, the CFO was unaware of the errors and there is no indication of gross negligence. The fact the auditors did not discover the errors suggests that they were not obvious.

Things to remember:
SOX prohibits officers and directors of issuers from misleading or fraudulently influencing an auditor if they know, or should know, that it could result in materially misstated financial statements.

Question 7 of 29

How many audits of public companies per year does a CPA firm that is registered with the Public Company Accounting Oversight Board (PCAOB) have to perform before it receives an annual inspection from the PCAOB?

A. One audit.

B. More than 10 audits.

C. More than 50 audits.

D. More than 100 audits. ✓

Explanation:

PCAOB inspections of firms auditing issuers	
100 or fewer audits of issuers per year	**More than 100 audits of issuers per year**
Inspected every three years	Inspected every year

Following numerous accounting scandals at public companies, Congress passed the Sarbanes-Oxley Act of 2002 (SOX). Among other provisions, SOX established the Public Company Accounting Oversight Board (PCAOB), a nongovernmental nonprofit organization, to register and oversee auditors of public companies. Accounting firms must be registered with the PCAOB to audit issuers.

The PCAOB maintains registrations for accounting firms that audit issuers, sets the standards by which those firms operate, and inspects registered firms. PCAOB inspections ensure compliance with PCAOB rules, SOX, SEC regulations, and any other applicable regulations or professional standards. The inspections involve reviewing both individual audits and a firm's system of quality control. Firms performing 100 or fewer audits per year are inspected every three years **(Choices A, B, and C)**. **Firms** performing **more than 100 audits** per year are **inspected annually**.

Things to remember:
The PCAOB registers accounting firms that audit public companies, sets standards for the audits, and inspects the registered firms. Firms performing 100 or fewer audits per year are inspected every three years. Firms performing more than 100 audits per year are inspected annually.

Question 8 of 29

According to the SEC, an auditor is **not** independent of its issuer audit client in which of the following situations?

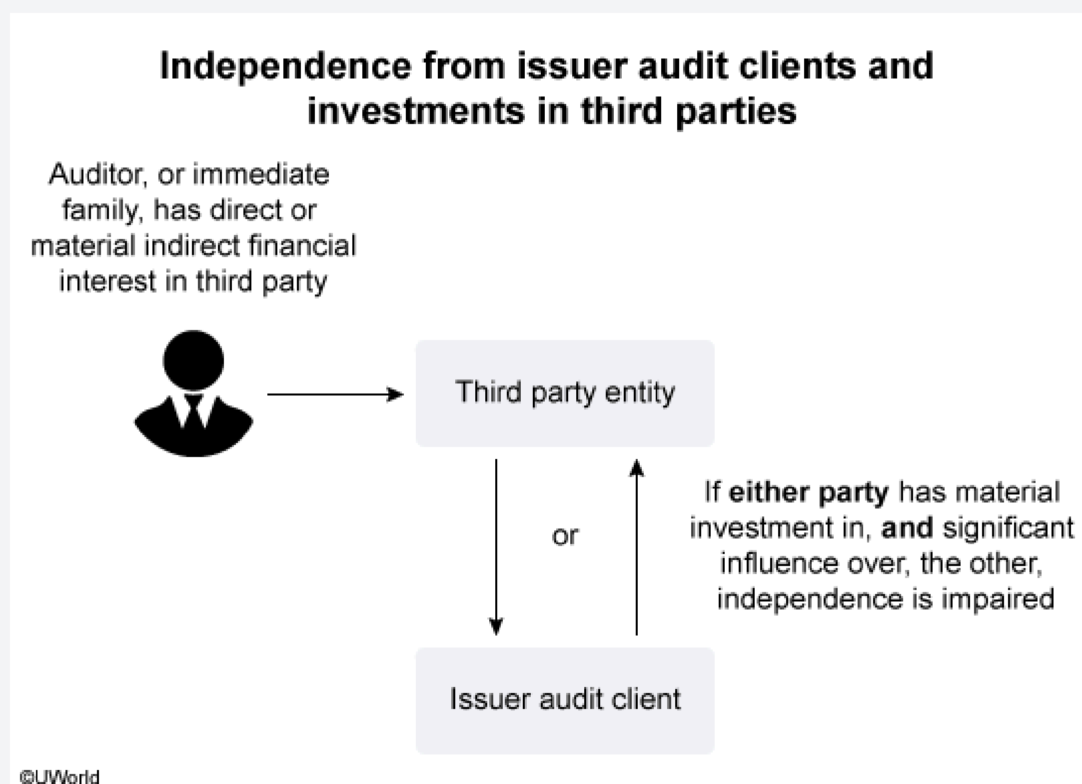
A. The auditor's cousin has an insurance policy obtained from the issuer before it became an audit client.

B. The auditor has an automobile loan at standard terms from the audit client that is collateralized by the automobile.

C. The auditor has an investment in an entity that has the ability to exercise significant influence over the audit client. ✓

D. The auditor's grandparent was in an accounting role at the audit client and ended employment before the period under audit began.

Explanation:



When performing attest services, CPAs issue reports on information provided by clients. If users do not trust the CPA to provide an objective assessment, they may not trust the report. Accordingly, CPAs performing attest services must be independent from the client in both fact and appearance.

A direct or material indirect financial interest *in the client*, whether held by a CPA or the CPA's immediate family, impairs independence. If the **client is** an issuer, independence can also be impaired by a **direct or material indirect financial interest in** *a third party* if:

- the **third party has** a material investment in and ability to exercise **significant influence over** the **client**, *or*

- the client has a material investment in and ability to exercise significant influence over the third party.

This restriction protects against potential conflicts of interest. For example, if litigation arises between the client and the third party, the CPA's work may be influenced by an adverse interest or undue influence threat.

(Choices A and D) According to SEC regulations, only spouses, spouse equivalents, dependents, parents, siblings, and nondependent children are considered close family members. Because cousins and grandparents are not close family members, their dealings with a client will not ordinarily impair independence.

(Choice B) An automobile loan collateralized by the automobile will not impair independence if obtained on standard terms.

Things to remember:
If a CPA or the CPA's immediate family holds direct or material indirect financial interests in a third party, independence is impaired if either the third party or the client has a material investment in and significant influence over the other.

Question 9 of 29

A cooling-off period of how many years is required before a member of an issuer's audit engagement team may begin working for the registrant in a key position?

A. One year. ✓

B. Two years.

C. Three years.

D. Four years.

Explanation:

Independence requirements of Sarbanes-Oxley for audits of issuers

• Auditor must cool off for one year before taking key role with client
• Auditor cannot perform most nonaudit services for audit clients
• Auditor must report to audit committee:
  ◦ Critical accounting policies and practices
  ◦ Alternative accounting discussed with management
  ◦ Material written communication between auditor and management
• Audit partner and reviewing partner must rotate off engagement every five years
• Audit committee must preapprove nonaudit services provided

The Sarbanes-Oxley Act of 2002 (SOX) created the PCAOB and imposed wide-ranging requirements on publicly traded companies (ie, registrants) and their auditors. Several such requirements made independence rules more stringent.

SOX prohibits an accounting firm from providing **audit** services for an **issuer** if anyone in a **financial oversight role** (eg, CEO, CFO, chief administrative officer, controller) for the client was employed by the firm and participated in an audit of the client during the **one-year** period **preceding** the current audit. This requirement prevents the former member of the audit team from having an undue influence on the performance of the audit. It also mitigates a potential threat caused by excess familiarity between auditor and client.

Things to remember:
The Sarbanes-Oxley Act tightened independence requirements for auditors of public companies in several ways. One key restriction prevents firms from performing audits for issuers if anyone in a financial oversight role with the client worked for the firm on the client's audit within one year preceding the audit.

Question 10 of 29

Under the Sarbanes-Oxley Act of 2002, exactly how many consecutive years may an audit partner lead an audit for an issuer?

A. Four years.

B. Five years. ✓

C. Six years.

D. Seven years.

Explanation:

Independence requirements of Sarbanes-Oxley for audits of issuers

• Auditor must cool off for one year before taking key role with client
• Auditor cannot perform most nonaudit services for audit clients
• Auditor must report to audit committee:
  ○ Critical accounting policies and practices
  ○ Alternative accounting discussed with management
  ○ Material written communication between auditor and management
• Audit partner and reviewing partner must rotate off engagement every five years
• Audit committee must preapprove nonaudit services provided

The Sarbanes-Oxley Act (SOX) created the Public Company Accounting Oversight Board (PCAOB) and imposed sweeping requirements on issuers and their auditors. Several such requirements made auditor independence rules stricter.

A long, uninterrupted relationship between auditor and client can create a real or perceived familiarity threat to the auditor's independence. For this reason, **SOX** requires that the **partner** in charge of an **audit** of an **issuer** and the partner responsible for reviewing that audit can be on the engagement for **only five consecutive years**. When partners rotate off an engagement, another SEC rule requires that they not return to the client's audits for another five years.

(Choices A and C) There are no four- or six-year rules relating to auditor rotation.

(Choice D) The seven-year rule refers to the length of time following the report release date that auditors are required to retain workpapers on audits of issuers.

Things to remember:
The Sarbanes-Oxley Act tightened independence requirements for auditors of public companies in several ways. One key restriction requires that the lead partner on the audit of an issuer (and the partner responsible for reviewing that audit) can serve no more than five uninterrupted years on that client's audits.

Question 11 of 29

According to the PCAOB, which of the following tax services may be provided jointly with the audit of an issuer's financial statements without impairing independence?

A. Planning and issuing an opinion in favor of the tax treatment of an aggressive tax position.

B. Reviewing a proposed transaction and informing the client of the tax consequences. ✓

C. Providing consultations under a contingency fee arrangement.

D. Preparing tax returns for an individual in a financial oversight reporting role during the audit period.

Explanation:

Tax services prohibited for issuer audit clients
• Recommending an aggressive tax position • Providing any tax service for person in key position with client • Using contingent fee arrangements (even if not tax related) • Advocating for client in a tax dispute

If an accounting firm performs nonaudit services for an audit client, threats to the firm's independence may arise. To prevent such threats, Sarbanes-Oxley restricts CPAs from offering most nonaudit services to issuer audit clients.

If preapproved by the audit committee, tax services such as return preparation *are* generally allowed, even for issuer audit clients. In such cases, a client's interests are neither aligned with nor in conflict with a CPA's. By reviewing a proposed transaction for tax consequences, for example, the CPA is only providing the results of research. No independence problem is created.

However, tax services that create an actual or perceived alignment of the interests of the firm with the interests of the client (eg, advocating for the client) create an independence threat. For this reason, the PCAOB**prohibits** such tax services for **issuer audit** clients.

(Choice A) Recommending *aggressive* tax positions may put the auditor at odds with the client if those positions are disallowed by tax authorities.

(Choice C) *Contingent* fee arrangements, by definition, align the interests of the CPA with those of the client.

(Choice D) Providing tax services for anyone in a *financial reporting oversight role* with the client creates the appearance of a mutual interest between CPA and client.

Things to remember:
When auditing issuers, CPAs can perform some tax services without impairing independence, if preapproved by the audit committee. However, CPAs may not

recommend aggressive tax positions, provide tax services to anyone in a key position, or accept contingent fee arrangements.

Question 12 of 29

Each of the following statements regarding the Public Company Accounting Oversight Board (PCAOB) is true **except**:

A. Public accounting firms must register with the PCAOB to perform audits of public companies.

B. The PCAOB is a private, nonprofit organization established in 1933. ✓

C. Two of the five PCAOB board members must be CPAs.

D. The PCAOB is responsible for enforcing the Sarbanes-Oxley Act.

Explanation:

Powers of the PCAOB
• Registers accounting firms, allowing them to audit issuers • Establishes audit, ethics, and quality control standards for auditors of issuers • Investigates and disciplines violations by accounting firms • Performs quality control inspections of registered accounting firms • Enforces compliance with the Sarbanes-Oxley Act through administrative sanctions

In 2002, Congress established the PCAOB to regulate public company auditors. The SEC appoints the PCAOB's five-member board, which consists of two CPA members and three non-CPA members **(Choice C)**.

The **PCAOB** is a **private sector**, **nonprofit organization** responsible for enforcing the SOX Act **(Choice D)**. Congress passed the SOX Act in response to a series of massive accounting frauds that rocked the financial market in the early 2000s. The PCAOB has the authority to create public company audit standards, set ethics and independence rules, inspect public accounting firms, hold disciplinary hearings, and investigate violations of the SOX Act.

To comply with the SOX Act, accounting firms must register with the PCAOB before they are permitted to audit public companies **(Choice A)**.

Things to remember:
The PCAOB is a private, nonprofit organization created to enforce requirements of the SOX Act. The PCAOB's leadership team is a five-person board consisting of two CPAs and three non-CPAs. Accounting firms must register with the PCAOB before they can audit public companies.

Question 13 of 29

An issuer may hire an employee of a registered public accounting firm who served on the audit engagement team within the previous year for which of the following positions?

A. Controller.

B. CFO.

C. CEO.

D. **Staff accountant.** ✓

Explanation:

Key positions (financial reporting oversight roles)	
Definition	**Examples**
Any position that gives the ability to exercise influence over financial statements	• CEO • CFO • Controller • Director of internal audit

It is common for CPAs working in public accounting to subsequently work for a client. However, when the client is an attest client there is a risk that the CPA's remaining ties to the firm may impair the firm's independence. When the client is an issuer, the SEC's stricter independence rules apply.

A CPA firm may not **audit** an **issuer** if anyone in a **financial oversight role** (eg, CEO, CFO, controller) with the client worked for the firm and **participated** in an **audit** of the **client** within **one year** of the current audit **(Choices A, B, and C)**. This requirement prevents the former member of the audit team from having an undue influence on the performance of the current audit. It also mitigates a potential threat presented by excess familiarity between auditor and client.

Because a **staff-level** accountant has **no** significant **influence** over the content or preparation of an entity's financial statements, former employment of a staff-level accountant by an auditing firm would **not affect** the firm's **independence**.

Note: The AICPA Code of Professional Conduct uses the term "key position" instead of "financial reporting oversight role," but the terms are essentially equivalent.

Things to remember:
SEC independence rules prevent firms from performing audits for issuers if anyone in a financial oversight role (eg, CEO, CFO, controller) with the client worked for the firm on an audit of the client within one year of the current audit.

Question 14 of 29

At least how often should the PCAOB inspect a registered public accounting firm that regularly issues audit reports to 50 issuers?

A. Annually.

B. Every two years.

C. Every three years. ✓

D. As requested by the firm.

Explanation:

Powers of the PCAOB
• Registers accounting firms, allowing them to audit issuers • Establishes audit, ethics, and quality control standards for auditors of issuers • Investigates and disciplines violations by accounting firms • Performs quality control inspections of registered accounting firms • Enforces compliance with the Sarbanes-Oxley Act through administrative sanctions

Following numerous scandals involving the audits of public companies, Congress passed the Sarbanes-Oxley Act of 2002 (SOX). SOX established the Public Company Accounting Oversight Board (PCAOB) to register and oversee auditors of public companies. Accounting firms must be registered with the PCAOB to audit issuers.

The PCAOB maintains registrations for accounting firms that audit issuers, sets standards by which those firms operate, and inspects registered firms. PCAOB inspections ensure compliance with SOX, PCAOB rules, SEC regulations, and any other applicable professional standards or regulations. The inspections involve reviewing individual audits and a firm's system of quality control. Firms performing more than 100 audits per year are inspected annually. **Firms** performing **100 or fewer audits per year** are **inspected every three years**.

Things to remember:
The PCAOB registers accounting firms that audit public companies, sets standards for the audits, and inspects the registered firms. Firms performing more than 100 audits per year are inspected annually. Firms performing 100 or fewer audits per year are inspected every three years.

Question 15 of 29

According to the SEC, members of an issuer's audit committee may **not**

A. Establish procedures for employees to anonymously report fraud.

B. Be responsible for the compensation of any registered public accounting firm employed by the entity to provide an audit report.

C. Accept any consulting, advisory, or other compensation fee from the entity for services other than as a member of the board. ✓

D. Engage independent counsel as deemed necessary to carry out their duties.

Explanation:

Audit committee functions

- Oversee financial reporting process
- Ensure financial information is reliable and available to stakeholders
- Present annual audit to board
- Recommend external auditors
- Oversee audit and control systems

The audit committee (A/C) consists of **independent members** of the board of directors (BOD). Independent members are not employed by the entity, are not shareholders, have no financial relationship with the entity, and are otherwise unattached to the entity.

The Securities Exchange Act of 1934 specifies that an A/C member may receive compensation such as director fees, retainers, and meeting fees for serving on the board and/or committees but may not:

- Accept any other consulting, advisory, or compensatory fee from the company.
- Be affiliated with the company.

The A/C is responsible for overseeing the:

- Financial reporting process, making certain that reliable information useful to stakeholders is available on a timely basis.
- Appointment and compensation of the entity's auditors **(Choice B)**.
- Establishment of appropriate internal controls, including programs for the prevention and detection of fraud.
- Creation and publication of a code of ethics for senior financial officers.
- Establishment of a process for employees to anonymously report concerns about accounting matters and/or fraud **(Choice A)**.
- Engagement of independent counsel as deemed necessary **(Choice D)**.

Things to remember:
The audit committee (A/C) consists of independent members of the board of directors. They are not employed by the entity, are not shareholders, have no financial relationship

with the entity, and are otherwise unattached to the entity. An A/C member may receive compensation such as director fees, retainers, and meeting fees but may not accept any other consulting, advisory, or compensatory fee from the company.

Question 16 of 29

According to the Sarbanes-Oxley Act of 2002, which of the following nonaudit services is a registered public accounting firm allowed to perform for an audit client when preapproved to do so by the audit committee?

A. Post client-approved journal entries.

B. Appraise an asset belonging to the client.

C. Perform internal audit services.

D. Prepare the client's tax return. ✓

Explanation:

SOX Title II: Prohibited nonaudit services for issuer audit clients

Self-review threat	• Services related to accounting records (eg, bookkeeping) • Information system design or implementation • Appraisal/valuation services • Actuarial services
Perceived as conflict	• Internal audit outsourcing services • Management or human resources functions • Broker dealer investment advisor or banking services • Legal services and expert services that are **unrelated** to audit
Others	• Any other services the SOX board determines impermissible

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The **Sarbanes-Oxley Act** (SOX) was enacted to protect investors from fraudulent or otherwise inaccurate financial reporting by public companies. It imposes stringent requirements on issuers and their auditors. Several such restrictions prohibit performing many nonaudit services (eg, appraisal, bookkeeping, internal auditing) for audit clients to limit independence threats.

However, **auditors** are **permitted** to perform certain other nonaudit services for issuer audit clients, including most tax services (eg, **preparing** a client's **tax return**), **if** the service is **preapproved** by the client's **audit committee**.

(Choice A) The AICPA's Code of Professional Conduct allows an auditor to post journal entries for a client if the client approves each entry. However, SOX imposes higher standards on auditors of public companies, including a prohibition on providing *any* nonaudit services related to accounting records.

(Choice B) An audit involves assessing the reasonableness of asset appraisals. Therefore, a CPA firm that appraised an asset for an audit client would be in a position of reviewing its own work (self-review) in the audit, impairing its independence.

(Choice C) If a firm performs internal audit services for a client, it participates in the client's decision making (management participation) and may also be in the position of

reviewing its own work.

Things to remember:
Auditors are prohibited from performing many nonaudit services for issuer audit clients, including internal audit outsourcing, appraisals, and bookkeeping. However, certain nonaudit services, such as tax services, generally can be performed with preapproval from the issuer's audit committee.

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Zoe has served as the audit partner for CPA firm OVB's audit of ABC Corp., an issuer, for each of the past five years. Which of the following is true regarding next year's audit of ABC?

	Zoe may serve as the audit partner	*OVB may serve as the auditing firm*
A.	Yes	Yes
B.	Yes	No
C.	**No**	**Yes**
D.	No	No

Explanation:

Independence requirements of Sarbanes-Oxley for audits of issuers

• Auditor must cool off for one year before taking key role with client
• Auditor cannot perform most nonaudit services for audit clients
• Auditor must report to audit committee:
  ◦ Critical accounting policies and practices
  ◦ Alternative accounting discussed with management
  ◦ Material written communication between auditor and management
• Audit partner and reviewing partner must rotate off engagement every five years
• Audit committee must preapprove nonaudit services provided

The Sarbanes-Oxley Act (SOX) imposed far-reaching requirements on issuers and their auditors. Several of the requirements made the rules on auditor independence stricter.

A long, uninterrupted relationship between an auditor and client can create a real or perceived familiarity threat to the auditor's independence. For this reason, SOX mandates that both the **partner** in charge of an **audit** of an **issuer** and the partner responsible for reviewing that audit can be on the engagement for **only five consecutive years**. When partners rotate off an engagement, another SEC rule requires that they not return to the client's audits for another five years.

Although the PCAOB requires that an issuer's audit report **disclose** the year the CPA firm began serving consecutively as the company's auditor (ie, **auditor tenure**), there is **no limit** to the length of the **firm's tenure**. In this case, Zoe must come off the engagement, but OBV may continue to audit ABC.

Things to remember:
Although the audit partner and reviewing partner must rotate off the engagement of an issuer every five years, there is no requirement that the auditing firm do so.

Question 18 of 29

According to the PCAOB, each of the following statements is true with respect to the auditor's responsibility to communicate material weaknesses in internal control over financial reporting, **except**

A. All such weaknesses must be communicated in writing to the audit committee.

B. All such weaknesses must be communicated in writing to management.

C. All such weaknesses must be communicated prior to the issuance of the auditor's report on internal control over financial reporting.

D. All such weaknesses must be communicated in writing to all stockholders. ✓

Explanation:

Communicating I/C issues: PCAOB rules	
Applies to	Issuers
When to report	Prior to issuing audit report on internal control over financial reporting (ICFR)
Written report to management	All deficiencies in ICFR
Written report to audit committee	Material weaknesses, significant deficiencies
Notify audit committee	When management has received written report of all deficiencies

When an **issuer** is audited, PCAOB rules require that the auditor give **written notification** to the client of all **deficiencies** in internal control over financial reporting (**ICFR**) identified during the audit:

- **Material weaknesses** and **significant deficiencies** must be communicated to **both** the **audit committee** and **management (Choice A)**
- **Other ICFR deficiencies** should be communicated to **management** but do not need to be reported to the audit committee **(Choice B)**. After all identified ICFR deficiencies are reported to management, the auditor should inform the audit committee that this has been done.
- All communications regarding ICFR should be made in a timely manner and **before** the **audit report** on ICFR is **issued (Choice C)**.

Such communications are intended for only management and those charged with governance, **not stockholders**. Any material weaknesses (but not other ICFR

deficiencies) will be identified in the auditor's report on ICFR, available to stockholders and any other interested parties.

Note: Requirements for communicating ICFR deficiencies are significantly different for nonissuers.

Things to remember:
In an issuer's audit, material weaknesses and significant deficiencies in internal control over financial reporting (ICFR) must be reported in writing to the audit committee and management. Other ICFR deficiencies should be reported to management. All communications of ICFR deficiencies should be made in writing no later than the date of the auditor's report on ICFR.

Question 19 of 29

An issuer's auditor is prohibited from providing tax services to which of the following individuals?

A. The chair of the board of directors.

B. The chair of the audit committee.

C. The CEO. ✓

D. The CFO of an affiliate of the issuer audited by another firm.

Explanation:

Tax services for anyone in a key position with an issuer audit client
Prohibited, *unless* the person in the key position is: • A director but does *not also* occupy a key *management* position • With an affiliate whose financial statements are *immaterial* to client • With an affiliate whose financial statements are audited by *different* firm • Not in the position when the audit *begins*

If a CPA performs both audit and nonaudit services for a client, independence threats may arise. To prevent that, the Sarbanes-Oxley Act restricts CPAs from offering most nonaudit services to issuer audit clients.

If preapproved by the audit committee, tax services *are* generally allowed. However, tax services that create an actual or perceived conflict or alignment of the firm's interests with the client's interests pose an independence threat.

For this reason, the PCAOB**prohibits** providing **tax services** to an **issuer audit client's** CEO, or anyone else in a **financial reporting oversight role** (ie, a key position), with a few exceptions. CPAs *can* provide tax services to those in the following key positions with an issuer audit client:

- directors, provided they don't also occupy a key management position (eg, CEO, CFO) **(Choices A and B)**
- those in key positions with the client's affiliates, provided the affiliate's financial statements are immaterial to the client or are audited by another firm **(Choice D)**
- those who weren't in key positions when the audit began, provided that the services are completed within 180 days of the positions being filled

Things to remember:
CPAs generally cannot offer tax services to anyone in a financial reporting oversight role with an issuer audit client when the audit begins. Exceptions are allowed if the person's

only role is as a director or if the person works for either an affiliate that is audited by another firm or for an affiliate whose financials are immaterial to the client.

Question 20 of 29

Rules issued under the Sarbanes-Oxley Act of 2002 restrict former members of an audit engagement team from accepting employment as a chief executive, chief financial or chief accounting officer, or controller of an audit client that files reports with the Securities and Exchange Commission. How many annual audit period(s) must be completed before such employment can be accepted?

A. One. ✓

B. Two.

C. Three.

D. Five.

Explanation:

Independence requirements of Sarbanes-Oxley for audits of issuers

• Auditor must cool off for one year before taking key role with client
• Auditor cannot perform most nonaudit services for audit clients
• Auditor must report to audit committee:
  ◦ Critical accounting policies and practices
  ◦ Alternative accounting discussed with management
  ◦ Material written communication between auditor and management
• Audit partner and reviewing partner must rotate off engagement every five years
• Audit committee must preapprove nonaudit services provided

The Sarbanes-Oxley Act (SOX) was enacted in response to numerous accounting scandals at public companies. It imposes wide-ranging and stringent requirements on issuers and their auditors, including several relating to independence.

SOX **prohibits** anyone who worked on the **audit** of an **issuer** from taking a **financial oversight role** (eg, CEO, CFO, CAO, controller) for the client within a **one-year** cooling-off period. In other words, if a CPA participated in the client's Year 1 audit, the CPA cannot be in a key position with the client during the Year 2 audit. This requirement prevents the CPA from having an undue influence on the performance of the audit and mitigates a potential familiarity threat.

(Choices B and C) Two- and three-year time spans do not relate to SOX independence requirements.

(Choice D) Five years is the maximum time an audit partner assigned to an issuer client can remain on the audit without rotating off.

Things to remember:
The Sarbanes-Oxley Act tightened requirements on public companies and their auditors. Firms cannot perform audits for issuers if anyone in a key position with the client (eg,

CEO, CFO, controller) worked for the firm on the client's audit within a one-year cooling-off period preceding the current audit.

Question 21 of 29

According to the Sarbanes-Oxley Act of 2002, which of the following is a corporate responsibility requirement for public entity issuers?

A. Certifying that no material weaknesses in internal controls over financial reporting exist as of the end of the reporting period.

B. Certifying that financial statements are fairly presented and not materially misleading to the external auditor. ✓

C. Ensuring that the external auditor is hired, compensated, and communicated with directly by management.

D. Ensuring that deficiencies in internal controls have been disclosed by the independent audit committee.

Explanation:

Sarbanes-Oxley (SOX) corporate responsibility requirements for issuers
• Independent audit committee hires, compensates, and communicates with auditor • CEO and CFO certify that financial statements are fairly presented • CEO and CFO take responsibility for internal controls and disclose deficiencies • Officer/director prohibited from materially misleading auditor (eg, fraud) • If earnings are restated, executive bonuses can be clawed back (ie, taken back) • SEC may bar violators of securities laws from serving as officer/director

The Sarbanes-Oxley (SOX) Act is a law enacted by Congress in response to numerous accounting scandals at public companies. **Corporate responsibility requirements** were included in SOX to **restore investor confidence** in public companies.

Corporate responsibility requirements were designed to hold executives (CEOs and CFOs) responsible for the accuracy of financial reporting. Under SOX, management must **certify that F/S are fairly presented** and **not materially misleading**.

(Choice A) *Management* is responsible for evaluating the effectiveness of internal controls over financial reporting, but there is *no* obligation to certify the *absence* of weaknesses.

(Choice C) Per SOX, public companies must have an independent audit committee. The *audit committee* oversees the hiring of, compensation of, and communication with external auditors.

(Choice D) The audit committee oversees financial reporting, internal controls, and the work of internal and external auditors. However, it is *management's responsibility* to ensure that deficiencies have been corrected and disclosed, as management is ultimately responsible for the accuracy of financial reporting.

Things to remember:
Under SOX, CEOs and CFOs have a responsibility to certify that F/S are fairly presented

and for ensuring that they do not materially mislead the auditor.

Question 22 of 29

Which of the following statements with respect to the Public Company Accounting Oversight Board rules on independence is correct?

A. Public confidence would usually **not** be impaired by the existence of circumstances that reasonable people might believe likely to influence independence.

B. Auditors should be independent in fact but are **not** obligated to avoid situations that could lead outsiders to doubt their independence.

C. Independence implies the attitude of a prosecutor that recognizes an obligation for fairness to management and other stakeholders.

D. Auditors must be without bias with respect to a client in order to maintain the impartiality necessary for the dependability of audit findings. ✓

Explanation:

Independence requirements of Sarbanes-Oxley for audits of issuers

• Auditor must cool off for one year before taking key role with client
• Auditor cannot perform most nonaudit services for audit clients
• Auditor must report to audit committee:
  ◦ Critical accounting policies and practices
  ◦ Alternative accounting discussed with management
  ◦ Material written communication between auditor and management
• Audit partner and reviewing partner must rotate off engagement every five years
• Audit committee must preapprove nonaudit services provided

The Sarbanes-Oxley Act (SOX) created the Public Company Accounting Oversight Board (PCAOB) and imposed additional requirements on issuers and their auditors. Several of those requirements tightened auditor independence rules.

These rules are in place to help **auditors** remain **without bias**. Impartiality leads to reliable auditors' findings and supports independence. For example, one rule states audit partners must rotate off engagements every five years. While audit partners often build strong working relationships with a client's senior management, these relationships can develop into friendships over time, potentially biasing the auditor. The rotation requirement helps minimize potential bias.

(Choices A and B) Auditors must remain independent in both fact and *appearance*. Independence in appearance addresses the need to avoid circumstances that would make the auditor look as if independence is lacking.

(Choice C) PCAOB independence rules apply to all auditors, who bear a responsibility to serve the public interest rather than an obligation for fairness to management or other stakeholders.

Things to remember:
According to the PCAOB rules on independence, auditors must be without bias with

respect to a client in order to maintain the impartiality necessary for the reliability of audit findings.

Question 23 of 29

Nguyen is the lead audit partner for BCD Accounting Firm's audit team for client Megga Corporation, a large publicly held company. Nguyen has been given a job offer at Megga. Which of the following positions can Nguyen accept and assume immediately without having to worry about violating SOX's independence rules?

A. CFO

B. CEO

C. CMO ✓

D. CAO

Explanation:

(Choice A) Incorrect. Clearly Nguyen can't immediately become CFO.

(Choice B) Incorrect. Clearly Nguyen can't immediately become CEO.

(Choice C) Correct! Chief marketing officer is clearly the best choice among these four, but we'd still want to inquire as to whether the CMO has any financial oversight role.

(Choice D) Incorrect. Clearly Nguyen can't immediately become CAO.

Question 24 of 29

As specified in Title I of the Sarbanes-Oxley Act of 2002, which organization has oversight and enforcement authority over the Public Company Accounting Board (PCAOB) and its decisions?

A. The AICPA

B. **The SEC** ✓

C. The FASB

D. The Treasury Department

Explanation:

Choice B (Correct) and Choices A, C, D (Incorrect): The Securities and Exchange Commission (SEC) has oversight and enforcement authority over the PCAOB. The AICPA is a professional organization that is only authorized to regulate those CPAs who choose to be members. The FASB is the body designated by the SEC to have responsibility for GAAP. The Treasury Department is responsible for printing and minting money, collecting federal taxes, and managing US government debt instruments.

Question 25 of 29

Which of the following nonaudit services does the Sarbanes-Oxley Act permit firms providing attest services to perform for attest clients?

A. **Tax consulting.** ✓

B. Actuarial services.

C. Investment advisory services.

D. Expert services unrelated to the audit.

Explanation:

(Choice A) Correct! SOX permits tax consulting.

(Choice B) Incorrect. SOX forbids attest firms from providing actuarial services to public company attest clients.

(Choice C) Incorrect. SOX forbids attest firms from providing investment advisory services to public company attest clients.

(Choice D) Incorrect. SOX forbids attest firms from providing expert services unrelated to the audit to public company attest clients.

Question 26 of 29

Which of the following Boards has the responsibility to regulate CPA firms that audit public companies?

A. Auditing Standards Board.

B. Public Oversight Board.

C. Public Company Accounting Oversight Board. ✓

D. Accounting Standards Board.

Explanation:

Choice C (Correct): Sarbanes-Oxley established the Public Company Accounting Oversight Board and gave it the responsibility of setting auditing standards for auditors of public companies, those entities reporting to the SEC, and regulating the registered CPA firms that perform audits of public companies. The Auditing Standards Board establishes auditing standards for nonpublic entities. There is no Public Oversight Board that regulates CPAs. The Financial Accounting Standards Board is responsible for establishing generally accepted accounting principles for all entities, including public and nonpublic entities, but does not regulate CPA firms.

Choice A (Incorrect): Sarbanes-Oxley established the Public Company Accounting Oversight Board and gave it the responsibility of setting auditing standards for auditors of public companies, those entities reporting to the SEC, and regulating the registered CPA firms that perform audits of public companies. The Auditing Standards Board establishes auditing standards for nonpublic entities.

Choice B (Incorrect): Sarbanes-Oxley established the Public Company Accounting Oversight Board and gave it the responsibility of setting auditing standards for auditors of public companies, those entities reporting to the SEC, and regulating the registered CPA firms that perform audits of public companies. There is no Public Oversight Board that regulates CPAs.

Choice D (Incorrect): Sarbanes-Oxley established the Public Company Accounting Oversight Board and gave it the responsibility of setting auditing standards for auditors of public companies, those entities reporting to the SEC, and regulating the registered CPA firms that perform audits of public companies. The Financial Accounting Standards Board is responsible for establishing generally accepted accounting principles for all entities, including public and nonpublic entities, but does not regulate CPA firms.

Question 27 of 29

The Sarbanes-Oxley Act of 2002 prohibits the performance of certain services for audit clients by auditors of public companies. Which of the following is not prohibited?

A. Bookkeeping services.

B. Appraisal services.

C. Tax preparation services. ✓

D. Management functions.

Explanation:

(Choice A) This answer is incorrect because providing bookkeeping services for an attest client is prohibited.

(Choice B) This answer is incorrect because providing appraisal services for an attest client is prohibited.

(Choice C) This answer is correct because the act does not prohibit the performance of tax preparation services.

(Choice D) This answer is incorrect because providing management functions for an attest client is prohibited.

Question 28 of 29

In which of the following circumstances would a covered member's independence be impaired with respect to an "issuer" client under PCAOB auditing standards?

A. The member is designated to serve as guardian of a friend's children if the need arises, and the friend's estate, which would be held in trust for the children, holds significant stock ownership in a client entity.

B. The member's spouse qualifies because of geographical residence to belong to a client's credit union, and all transactions with the credit union are conducted under normal operating practices.

C. The member owns municipal utility bonds issued by a client, and the bonds are not material to the member's wealth. ✓

D. The member belongs to a client golf club that requires members to acquire a share of the club's debt securities.

Explanation:

Choice C (Correct): The auditor of an issuer may not have any direct financial interest in an audit client, including an investment in the client's bonds, regardless of whether or not it is material. Materiality is only relevant if the financial interest is indirect. Until such time as the auditor becomes trustee of the estate, the auditor does not have an interest, direct or indirect, in the entity. Being a member of a credit union would not impair a member's independence as long as all transactions are conducted under normal operating practices. Ownership of a share of a client golf club's debt securities would not impair independence if required as a prerequisite for membership.

Choices A, B, D (Incorrect): The auditor of an issuer may not have any direct financial interest in an audit client, including an investment in the client's bonds, regardless of whether or not it is material. Materiality is only relevant if the financial interest is indirect. Until such time as the auditor becomes trustee of the estate, the auditor does not have an interest, direct or indirect, in the entity. Being a member of a credit union would not impair a member's independence as long as all transactions are conducted under normal operating practices. Ownership of a share of a client golf club's debt securities would not impair independence if required as a prerequisite for membership.

Question 29 of 29

Charlie is an auditor whose firm audits Sitton Corporation, a publicly-held company. Under Sarbanes-Oxley, which of the following are NAS (Non-Audit Services) that Charlie's firm may perform for Sitton without impairing independence?

A. Actuarial services.

B. Tax advice. ✓

C. Internal audit outsourcing services.

D. Broker/dealer services.

Explanation:

(Choice A) Incorrect. Actuarial services are on SOX's prohibited list.

(Choice B) Correct! Tax advice is allowed by SOX.

(Choice C) Incorrect. Internal audit services are on SOX's prohibited list.

(Choice D) Incorrect. Broker/dealer services are on SOX's prohibited list.