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QUESTION 1

The cumulative effect of a change in accounting estimate should be shown separately:

- A. On the income statement above income from continuing operations.
- B. On the income statement after income from continuing operations and before extraordinary items.
- C. On the retained earnings statement as an adjustment to the beginning balance.
- D. It should not be recorded separately on any financial statement.

Correct Answer: D

Explanation:

Choice "d" is correct. A change in estimate is handled prospectively. No cumulative effect adjustment is made and no separate line item presentation is made on any financial statement. If a material change is being made, appropriate footnote disclosure is necessary.

Choices "a", "b", and "c" are incorrect, per the above explanation.

QUESTION 2

The determination of gross domestic product (GDP) by the expenditure approach would include:

- A. Net exports.
- B. Business profits.
- C. Compensation to employees.
- D. A capital consumption allowance.

Correct Answer: A

Explanation: Choice "a" is correct. The expenditure approach to computing GDP includes: Consumption Net exports Government expenditures Capital investment Choices "b", "c", and "d" are incorrect, per the above.

QUESTION 3

When reporting on conditions relating to an entity's internal control observed during an audit of the financial statements of a nonissuer, the auditor should include a:

- A. Description of tests performed to search for material weaknesses.
- B. Statement of positive assurance on internal control.
- C. Paragraph describing the inherent limitations of internal control.



D. Restriction on the use of the report.

Correct Answer: D

Explanation: Choice "d" is correct. When reporting on conditions relating to an entity's internal control observed during an audit of the financial statements, the auditor should include a restriction on the use of the report. Choice "a" is incorrect. The auditor would not include a description of tests performed to search for material weaknesses since the auditor is not in fact obligated to search for them. Choices "b" and "c" are incorrect. An auditor would make a statement of positive assurance on internal control and include a paragraph describing the inherent limitations of internal control in conjunction with an engagement to report on internal control. These comments would not be made when reporting on an entity's internal control in conjunction with an audit of the financial statements of a nonissuer.

QUESTION 4

An auditor may achieve audit objectives related to particular assertions by:

- A. Performing analytical procedures.
- B. Adhering to a system of quality control.
- C. Preparing audit documentation.
- D. Increasing the level of detection risk.

Correct Answer: A

Explanation:

Choice "a" is correct. The auditor relies on substantive tests to achieve audit objectives related to particular assertions. Analytical procedures are one type of substantive procedure.

Choice "b" is incorrect. CPA firms performing audits are required to adhere to a system of quality control, but adhering to such a system does not directly help the firm achieve specific audit objectives.

Choice "c" is incorrect. Audit documentation is used to record the results of audit procedures that have been performed to achieve audit objectives. Mere preparation of audit documentation does not achieve audit objectives.

Choice "d" is incorrect. Increasing the level of detection risk does not enable the auditor to achieve audit objectives related to a particular assertion.

QUESTION 5

As a company becomes more conservative with respect to working capital policy, it would tend to have a (n):

- A. Increase in the ratio of current liabilities to noncurrent liabilities.
- B. Decrease in the operating cycle.



C. Decrease in the quick ratio.

D. Increase in the ratio of current assets to noncurrent assets.

Correct Answer: D

Explanation:

RULE: Working capital policy is deemed to be more conservative as an increasing portion of an organization's long-term assets, permanent current assets, and temporary current assets are funded by long-term financing.

Choice "d" is correct. An increase in the ratio of current assets to non-current assets would be indicative of an increasingly conservative working capital policy. With no other information, an increase in current assets would indicate that a growing percentage of current assets are financed by non current liabilities and that, nominally, the absolute amount of working capital and the current ratio is improving.

Choice "a" is incorrect. An increase in the ratio of current liabilities to noncurrent liabilities would indicate that an increasing portion of our assets are funded by current liabilities, a more aggressive approach to working capital management.

Choice "b" is incorrect. A decrease in the operating cycle implies that the time to convert inventory into sales (receivables) and receivables into cash has decreased. Assuming no change in liabilities or sales, a decreased operating cycle infers declining current asset balances, greater funding of assets by current liabilities and a more aggressive rather than conservative working capital policy.

Choice "c" is incorrect. A decrease in the quick ratio would indicate that either temporary current assets are decreasing (and are therefore increasingly funded by current liabilities, indicating a more aggressive working capital policy) or that current liabilities are increasing, signaling a decrease in the amount of noncurrent liabilities used to fund temporary current assets, a sign of an increasingly aggressive working capital policy.

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