



CPA-TEST^{Q&As}

Certified Public Accountant Test: Auditing and Attestation, Business Environment and Concepts, Financial Accounting and Reporting, Regulation





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QUESTION 1

To obtain an understanding of a continuing client's business in planning an audit, an auditor most likely would:

- A. Perform tests of details of transactions and balances.
- B. Review prior-year audit documentation and the permanent file for the client.
- C. Read specialized industry journals.
- D. Reevaluate the client's internal control environment.

Correct Answer: B

Explanation: Choice "b" is correct. Knowledge of an entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of personnel of the entity. Audit documentation from prior years may contain useful information about the nature of the business, its organizational structure, its operating characteristics, and transactions that may require special consideration. Choice "a" is incorrect. Tests of details of transactions and balances are not performed during the planning

stage of an audit.

Choice "c" is incorrect. Reading industry journals would provide information about the industry in which the entity operates, but reviewing prior-year audit documentation and the permanent file would provide a more thorough understanding of the specific client's business.

Choice "d" is incorrect. The client's internal control is not reevaluated during the planning stage of an audit.

QUESTION 2

In a well designed internal control, employees in the same department most likely would approve purchase orders, and also:

- A. Reconcile the open invoice file.
- B. Inspect goods upon receipt.
- C. Authorize requisitions of goods.
- D. Negotiate terms with vendors.

Correct Answer: D

Explanation:

Choice "d" is correct. In a well designed internal control, employees in the purchasing department most likely would approve purchase orders and also negotiate terms with vendors.

Choice "a" is incorrect. Personnel in the accounts payable department reconcile the open invoice file while



the purchasing agent approves purchase orders.

Choice "b" is incorrect. Employees in the receiving department inspect goods upon receipt while the purchasing agent approves purchase orders.

Choice "c" is incorrect. The stores department (personnel in the raw materials inventory area) authorize requisition of goods while the purchasing agent approves purchase orders.

QUESTION 3

When do cost leadership strategies fail?

- A. Buyers have large amounts of bargaining power in the market.
- B. Heavy price competition exists in the market.
- C. Buyers become less price sensitive and start to have brand loyalty.
- D. New entry firms are able to influence buyers to switch to their product by cutting the price of their product for a period of time in an effort to gain market share and increase profits.

Correct Answer: C

Explanation:

Choice "c" is correct. If firms overlook the fact that few customers care about the fact that a product is priced lower than others and care more about brand loyalty, cost leadership strategies will fail.

Choices "a", "b", and "d" are incorrect, as these are all situations in which cost leadership strategies work well.

QUESTION 4

ABC Co.'s income statement for the year ended December 31, 1990, reported net income of \$74,100. The auditor raised questions about the following amounts that had been included in net income:

Unrealized loss on decline in market value of available-for-sale investments in stock	\$(5,400)
Gain on early retirement of bonds payable (net of \$11,000 tax effect)	22,000
Adjustment to profits of prior years for errors in depreciation (net of \$3,750 tax effect)	(7,500)
Loss from fire (net of \$7,000 tax effect)	(14,000)

The loss from the fire was an infrequent but not unusual occurrence in ABC's line of business. ABC's December 31, 1990, income statement should report net income of:

- A. \$65,000
- B. \$66,100



- C. \$81,600
- D. \$87,000

Correct Answer: D

Explanation:

Net income before adjustments

Net income before adjustments	\$74,100
Add: Unrealized loss in market value of available-for-sale investments in stock which should not have affected net income	5,400
Add: Correction of error of prior period which should not have affected net income	<u>7,500</u>
Net income after adjustments	<u>\$87,000</u>

Rule: Unrealized losses (or gains) resulting from changes in market value of available-for-sale investments should be reported as a component of other comprehensive income in shareholders' equity.

Unrealized gains and losses on investments held for trading would be included in net income.

Correction of errors of prior periods should be reported as an adjustment to beginning retained earnings, not as an item of net income.

Choice "d" is correct. \$87,000.

QUESTION 5

Which of the following statements is a basic element of the auditor's standard report?

- A. The disclosures provide reasonable assurance that the financial statements are free of material misstatement.
- B. The auditor evaluated the overall internal control.
- C. An audit includes assessing significant estimates made by management.
- D. The financial statements are consistent with those of the prior period.

Correct Answer: C

Explanation: Choice "c" is correct. The auditor's standard audit report includes a statement that "An audit includes assessing...significant estimates made by management..." Choice "a" is incorrect. The standard audit report does not state that disclosures provide reasonable assurance that the financial statements are free of material misstatement. The correct statement is: "...standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement." Choice "b" is incorrect. The standard audit report does not state that the auditor evaluated the overall internal control. The correct statement is "An audit includes...evaluating the overall financial statement presentation." Internal control is not mentioned in the standard audit report. Choice "d" is incorrect. The standard audit report does not state "The financial statements are consistent with those of the prior period." According to the second standard of reporting, consistency is implicitly reported. Only if there is an inconsistency is an explicit statement included.



QUESTION 6

During an audit an internal auditor may provide direct assistance to an independent CPA in:

	<i>Obtaining an understanding of internal control</i>	<i>Performing tests of controls</i>	<i>Performing substantive tests</i>
A	No	No	No
B	Yes	No	No
C	Yes	Yes	No
D	Yes	Yes	Yes

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D

Explanation:

Choice "d" is correct. Internal auditors may assist the auditor in obtaining an understanding of internal control and in performing tests of controls and substantive tests.

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

QUESTION 7

Why would a firm generally choose to finance temporary assets with short-term debt?

- A. Matching the maturities of assets and liabilities reduces risk.
- B. Short-term interest rates have traditionally been more stable than long-term interest rates.
- C. A firm that borrows heavily long term is more apt to be unable to repay the debt than a firm that borrows heavily short term.
- D. Financing requirements remain constant.

Correct Answer: A

Explanation: Choice "a" is correct. Matching the maturities of current assets with liabilities as they come due is designed to ensure liquidity and reduce risk of cash shortages. Temporary assets (such as inventories, generally, and seasonal



inventories, specifically) might be financed with short term debt such that the earnings from the sales of those temporary assets could be used to liquidate the related obligations as they come due and ensure that cash is available to meet cash flow requirements. Choice "b" is incorrect. Interest rate risks would likely motivate a firm to use longer term financing than short-term financing. Choice "c" is incorrect. Matching cash inflows with cash outflows are more influential in determining a firm's ability to repay debt rather than the length of the obligation. Choice "d" is incorrect. Long-term rather than short-term debt promotes consistent finance charges. The requirements for financing itself are driven by business practice, not by the maturity of financial instruments used.

QUESTION 8

Tracing shipping documents to prenumbered sales invoices provides evidence that:

- A. No duplicate shipments or billings occurred.
- B. Shipments to customers were properly invoiced.
- C. All goods ordered by customers were shipped.
- D. All prenumbered sales invoices were accounted for.

Correct Answer: B

Explanation:

Choice "b" is correct. By tracing from the shipping documents to the invoices, the auditor confirms that goods that were shipped were properly billed.

Choice "a" is incorrect. Tracing shipping documents to prenumbered invoices would not provide assurance that duplicate shipments or billings did not occur.

Choice "c" is incorrect. In order to test whether all goods that were ordered were shipped, the auditor would trace customer purchase orders to shipping documents.

Choice "d" is incorrect. Determining that all prenumbered sales invoices are accounted for does not require examining shipping documents.

QUESTION 9

When an accountant compiles a financial forecast, the accountant's report should include a(an):

- A. Explanation: of the differences between a financial forecast and a financial projection.
- B. Caveat that the prospective results of the financial forecast may not be achieved.
- C. Statement that the accountant's responsibility to update the report is limited to one year.
- D. Disclaimer of opinion on the reliability of the entity's internal controls.

Correct Answer: B



Explanation:

Choice "b" is correct. Whenever an accountant reports on prospective financial statements, the report should include a caveat that prospective results may not be achieved.

Choice "a" is incorrect. A compilation report on a financial forecast does not include an Explanation: of the differences between a forecast and a projection.

Choice "c" is incorrect. Whenever an accountant reports on prospective financial statements, the report should include a statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

Choice "d" is incorrect. A compilation report on a financial forecast does not include a disclaimer of opinion on the reliability of the entity's internal controls.

QUESTION 10

The trough of a business cycle is generally characterized by:

- A. Shortages of essential raw materials and rising costs.
- B. Increasing purchasing power and increasing capital investments.
- C. Unused productive capacity and an unwillingness to risk investments.
- D. Declining purchasing power and unused productive capacity.

Correct Answer: C

Explanation:

Choice "c" is correct. The trough of a business cycle is an economic low point with no positive indicators for the future. It is characterized by unused productive capacity and an unwillingness to risk new investments.

Choice "a" is incorrect. Shortages may occur during a peak.

Choice "b" is incorrect. Increasing purchasing power and increasing capital investments come with recovery.

Choice "d" is incorrect. Declining purchasing power comes with inflation; unlikely in a trough.

QUESTION 11

Within the framework of the aggregate demand/aggregate supply model, an increase in short run aggregate supply will

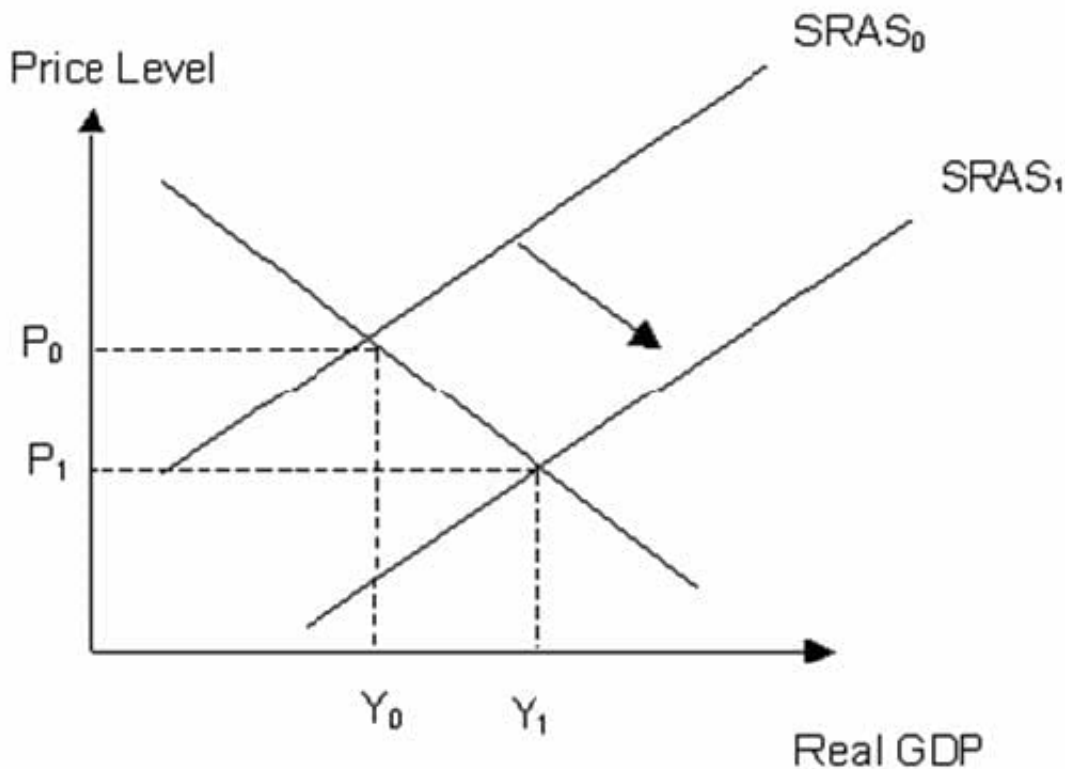


cause:

- A. Real output to expand and the price level to fall.
- B. Real output to decline and the price level to rise.
- C. Real output to expand and the price level to rise.
- D. Real output to decline and the price level to fall.

Correct Answer: A

Explanation:



Choice "a" is correct. A shift right in short run aggregate supply causes output to increase and the price level to fall.

Choice "b" is incorrect. Real output would rise, not fall.

Choice "c" is incorrect. The price level would fall, not rise.

Choice "d" is incorrect. Real output would rise, not fall.

QUESTION 12

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

- A. Decrease in its acid-test ratio.



- B. Increase in the ratio of current assets to units of output.
- C. Increase in funds invested in common stock and a decrease in funds invested in marketable securities.
- D. Decrease in its level of permanent working capital.

Correct Answer: B

Explanation:

Choice "b" is correct. As a company becomes more conservative in its working capital policy, it would tend to have an increase in the ratio of current assets to units of output.

Choice "a" is incorrect. Acid-test ratio would tend to increase with conservatism.

Choice "c" is incorrect. Marketable securities investments would tend to increase while common stock investments would tend to decrease.

Choice "d" is incorrect. Permanent working capital would tend to increase.

QUESTION 13

A disadvantage of the net present value method of capital expenditure evaluation is that it:

- A. Is calculated using sensitivity analysis.
- B. Does not provide the true rate of return on investment.
- C. Is difficult to apply because it uses a trial and error approach.
- D. Is difficult to adapt for risk.

Correct Answer: B

Explanation: Choice "b" is correct. The net present value (NPV) method of capital expenditure evaluation does not provide the true rate of return on investment. The NPV indicates whether or not an investment will earn the "hurdle rate" used in the NPV calculation. If the NPV is positive, the return on investment will exceed the hurdle rate. If the NPV is negative, the return on investment will be less than the hurdle rate. If the NPV is zero, the return on investment will be exactly equal to the hurdle rate.

Choice "a" is incorrect. Sensitivity analysis is a "what if" technique that asks how a given organization will change if the original estimates used in the capital budgeting model are changed.

Choice "c" is incorrect. NPV calculations do not use a trial and error approach.

Choice "d" is incorrect. NPV method is not difficult to adapt for risk. To adapt for increased risk, a higher hurdle rate is used. To adapt for less risk, a lower hurdle rate is used.

QUESTION 14



ABC, Inc. is interested in measuring its overall cost of capital and has gathered the following data. Under the terms described below, the company can sell unlimited amounts of all instruments.

- ABC can raise cash by selling \$1,000, 8 percent, 20-year bonds with annual interest payments. In selling the issue, an average premium of \$30 per bond would be received, and the firm must pay flotation costs of \$30 per bond. The after-tax cost of funds is estimated to be 4.8 percent.
- ABC can sell 8 percent preferred stock at par value, \$105 per share. The cost of issuing and selling the preferred stock is expected to be \$5 per share.
- ABC's common stock is currently selling for \$100 per share. The firm expects to pay cash dividends of \$7 per share next year, and the dividends are expected to remain constant. The stock will have to be underpriced by \$3 per share, and flotation costs are expected to amount to \$5 per share.
- ABC expects to have available \$100,000 of retained earnings in the coming year; once these retained earnings are exhausted, the firm will use new common stock as the form of common stock equity financing.
- ABC's preferred capital structure is:
Long-term debt 30%
Preferred stock 20
Common stock 50
If ABC, Inc. needs a total of \$200,000, the firm's weighted-average cost of capital would be closest to:
A. 4.8 percent.
B. 6.6 percent.
C. 6.8 percent.
D. 7.3 percent.

Correct Answer: B

Explanation:



Choice "b" is correct. 6.6%. ABC\ after tax cost of debt is 4.8% and cost of preferred stock is 8.4% (\$105/share less issue costs of \$5/share). The cost of equity (as calculated in a prior question) is 7.0%.

This question pertains to the manner in which changes in the required amount of capital will impact the weighted average cost of capital governed by the target capital structure. The rates are given, and you must derive the weights. The company needs a total of \$200,000. The question gives you the amount of Retained Earnings at \$100,000, the source of 7% dividend payments on common shares. If all that is needed is \$200,000, then, by definition, the target capital structure is "priced out" as shown with 7% common equity of \$100,000 being equal to 50% of the target capital structure totaling \$200,000 without any modification:

Type of financing	Cost	Target Structure	Extension
Long-term debt	4.8%	30%	1.44%
Preferred shares	8.4%	20%	1.68%
Common equity (Retained earnings)	7.0%	50%	3.50%
Total		100%	6.62%

Choices "a", "c", and "d" are incorrect, per the above Explanation.

QUESTION 15

Which one of the following would not be considered a carrying cost associated with inventory?

- A. Insurance costs.
- B. Cost of capital invested in the inventory.
- C. Cost of obsolescence.
- D. Shipping costs.

Correct Answer: D

Explanation:

Choice "d" is correct. Shipping costs (which are selling costs) would not be considered a carrying cost associated with inventory.

Choices "a", "b", and "c" are incorrect. Each of the following would be considered a carrying cost associated with inventory:

Insurance costs.

Cost of capital invested in the inventory.

Cost of obsolescence.



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