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QUESTION 1

The in-charge auditor most likely would have a supervisory responsibility to explain to the staff assistants:

- A. That fraud is not to be reported to those charged with governance.
- B. How the results of various auditing procedures performed by the assistants should be evaluated.
- C. What benefits may be attained by the assistants\' adherence to established time budgets.
- D. Why certain documents are being transferred from the current file to the permanent file.

Correct Answer: B

Explanation:

Choice "b" is correct. Assistants should be informed of their responsibilities and the objectives of the procedures that they are to perform. Part of the assistant\'s responsibility is to properly evaluate audit results, and the in-charge auditor would likely discuss this with them.

Choice "a" is incorrect. Fraud that causes a material misstatement or involves senior management should be reported to those charged with governance.

Choice "c" is incorrect. Preparation and maintenance of the time budget is related to planning rather than supervision.

Choice "d" is incorrect. The reasons for transferring documents from the permanent file to the current file need not be explained to the staff assistants.

QUESTION 2

When an entity changes its method of accounting for income taxes, which has a material effect on comparability, the auditor should refer to the change in an explanatory paragraph added to the auditor\'s report. This paragraph should identify the nature of the change and:

- A. Explain why the change is justified under generally accepted accounting principles.
- B. Describe the cumulative effect of the change on the audited financial statements.
- C. State the auditor\'s explicit concurrence with or opposition to the change.
- D. Refer to the financial statement note that discusses the change in detail.

Correct Answer: D

Explanation:

Choice "d" is correct. The paragraph should refer to the note in the financial statements that discusses the

change in detail. Following is an example of an appropriate explanatory paragraph: "As discussed in Note X to the financial statements, the company changed its method of accounting for income taxes in X2."

Choice "a" is incorrect. The auditor need not explain why a change from one generally accepted accounting principle to another is justified.

Choice "b" is incorrect. The paragraph should not identify the cumulative effect of the change on the audited financial statements.

Choice "c" is incorrect. The auditor should never explicitly state concurrence with a change. If the auditor opposes the change, a qualified or adverse opinion should be issued.

QUESTION 3

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 4

Reclassification adjustments must be shown in the financial statement that discloses comprehensive income:

- A. To show what portion of comprehensive income is from the realization of current assets.
- B. To show the tax effect of items of comprehensive income.
- C. To avoid double counting in comprehensive income items, which are currently displayed in net income.
- D. To avoid including transactions with shareholders in items of comprehensive income.

Correct Answer: C

Explanation:

Choice "c" is correct. Reclassification entries may be necessary to avoid double counting an item previously reported as comprehensive income (i.e., unrealized gain), which are now reported as part of net income (i.e., realized gain).

Choice "a" is incorrect. The classification of assets as current or non-current has no bearing on reporting comprehensive income.

Choice "b" is incorrect. All items of comprehensive income must be shown net of the related tax effects, but it is not done with reclassification adjustments.

Choice "d" is incorrect. Transactions with shareholders such as paying dividends and issuing capital stock are not included in comprehensive income, thus, reclassification adjustments are not necessary to exclude them.

QUESTION 5

Of the following items, the one item that would not be considered in evaluating the adequacy of the budgeted annual operating income for a company is:

- A. Return on assets.
- B. Long-range profit objectives.
- C. Industry average for earnings on sales.
- D. Internal rate of return.

Correct Answer: D

Explanation:

Choice "d" is correct. In evaluating the adequacy of the budgeted annual operating income, you would not use the internal rate of return calculation. The internal rate of return is used for capital budgeting.

Choices "a", "b", and "c" are incorrect. Return on assets, long range profit objectives, industry average for earnings on sales, and earnings per share [not mentioned as an option] are all measures for evaluating the adequacy of the budgeted annual operating income.

QUESTION 6

An accountant's standard report issued after compiling the financial statements of a nonissuer should state that:

- A. I am not aware of any material modifications that should be made to the accompanying financial statements.
- B. A compilation consists principally of inquiries of company personnel and analytical procedures.
- C. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
- D. A compilation is substantially less in scope than an audit in accordance with GAAS, the objective of which is the expression of an opinion.

Correct Answer: C

Explanation: Choice "c" is correct. An accountant's standard report issued after compiling the financial statements of a nonissuer should state that "a compilation is limited to presenting in the form of financial statements information that is the representation of management." Choice "a" is incorrect. A review report (and not a compilation report) states that, "I am not aware of any material modifications that should be made to the accompanying financial statements." Choice "b" is incorrect. A review report (and not a compilation report) states that a review "consists principally of inquiries of company personnel and analytical procedures." Choice "d" is incorrect. A review report (and not a compilation report) states that a review "is substantially less in scope than an audit in accordance with GAAS, the objective of which is the expression of an opinion."

QUESTION 7

All of the following capital budgeting analysis techniques use cash flows as the primary basis for the calculation, except for the:

- A. Net present value.
- B. Internal rate of return.
- C. Discounted payback period.
- D. Accounting rate of return.

Correct Answer: D

Explanation:

Choice "d" is correct. The accounting rate of return does not use cash flows as the primary basis for the calculation. It measures the accrual accounting return instead of cash flows:

$$\text{Accounting rate of return} = \frac{\text{Increase in expected average annual net income}}{\text{Average investment}}$$

Choice "a" is incorrect. Net present value method discounts cash flows for an investment over its life to time period zero using a desired or minimum rate of return. Choice "b" is incorrect. Internal rate of return (IRR) determines the compound

interest rate of an investment where the present value of the cash inflows equals the present value of the cash outflows. The IRR is the discount rate that results in a net present value of zero. Choice "c" is incorrect. The discounted payback period is the time period required for discounted cash inflows to equal the initial investment. The time value of money is considered.

QUESTION 8

To determine whether internal control relative to the revenue cycle of a wholesaling entity is operating effectively in minimizing the failure to prepare sales invoices, an auditor most likely would select a sample of transactions from the population represented by the:

- A. Sales order file.
- B. Customer order file.
- C. Shipping document file.
- D. Sales invoice file.

Correct Answer: C

Explanation:

Choice "c" is correct. Shipping documents provide evidence that a sale occurred, and therefore selecting from a population of shipping documents allows the auditor to test whether corresponding invoices exist for each sale.

Choices "a" and "b" are incorrect. The existence of customer orders and sales orders does not necessarily imply that a sale occurred. For example, the particular item requested may be out of stock.

In such cases, there would properly be no sales invoice.

Choice "d" is incorrect. Since the weakness the auditor is concerned about involves missing sales invoices, selecting from a sample of existing sales invoices would not identify this problem.

QUESTION 9

If management (of a governmental body) declines to present supplementary information required by the Governmental Accounting Standards Board (GASB), the auditor should issue a(an):

- A. Adverse opinion.
- B. Qualified opinion with an explanatory paragraph.
- C. Unqualified opinion.
- D. Unqualified opinion with an additional explanatory paragraph.

Correct Answer: D

Explanation:

Choice "d" is correct. If management (of a governmental body) declines to present information required by the GASB, the auditor should issue an unqualified opinion with an additional explanatory paragraph.

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

QUESTION 10

Which of the following statements is correct if there is an increase in the resources available within an economy?

- A. More goods and services will be produced in the economy.
- B. The economy will be capable of producing more goods and services.
- C. The standard of living in the economy will rise.
- D. The technological efficiency of the economy will improve.

Correct Answer: B

Explanation: Choice "b" is correct. If there is an increase in the resources available in an economy, the economy will be capable of producing more goods and services. This increase is really an increase in the long-run aggregate supply (potential GDP). On the aggregate supply and demand chart, the long-run aggregate supply line (LRAS) is the vertical line that represents the potential or equilibrium level of output. If that line shifts to the right, then the economy is capable of expanding, but it will not automatically expand just because the line shifts to the right. Choice "a" is incorrect. Just because there is an increase in the resources available in an economy, it does not mean that more goods and services will automatically be produced. There would have to be increased demand (a shift upward in the aggregate demand line) for more goods and services to actually be produced. Choice "c" is incorrect. If there is an increase in the resources available in an economy, the standard of living in the economy will not necessarily rise. It could rise, but it will not necessarily do that. Choice "d" is incorrect. If there is an increase in the resources available in an economy, the technological efficiency of the economy will not automatically improve. This statement is backwards. An increase in technological efficiency of an economy will normally increase the resources available in the economy by increasing productivity.

QUESTION 11

Which of the following securities are corporate debt securities?

<u>Convertible bonds</u>	<u>Debenture bonds</u>	<u>Warrants</u>
Yes	Yes	Yes
Yes	No	Yes
Yes	Yes	No
No	Yes	Yes

A. Option A

B. Option B

C. Option C

D. Option D

Correct Answer: C

Explanation:

Choice "c" is correct.

Rules: Bonds are debt securities. Thus, convertible bonds and debenture bonds are debt securities. A

warrant is a contractual right to purchase stock, which constitutes a share of corporate equity.

Choices "a", "b", and "d" are incorrect, per the above rules.

QUESTION 12

If an economy is currently experiencing both full employment and price stability, a major tax reduction will probably cause:

A. An increase in the unemployment rate.

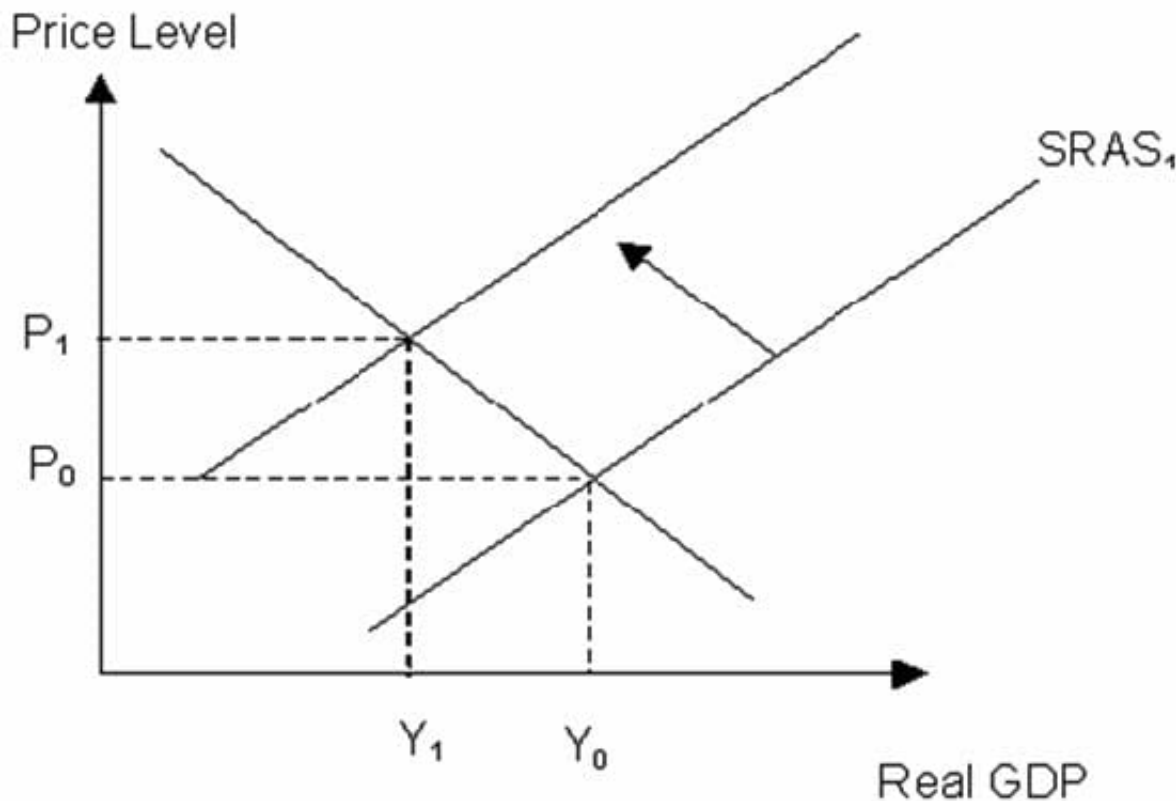
B. An acceleration in the inflation rate, unless government expenditures are also reduced.

C. No change in real GDP or the price level.

D. A decrease in consumption.

Correct Answer: B

Explanation:



Choice "b" is correct. A tax cut shifts the aggregate demand curve to the right causing the price level and therefore the inflation rate to rise.

Choice "a" is incorrect. The unemployment rate would fall, not rise.

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

Choice "d" is incorrect. Consumption would rise as disposable income rises, not fall.

QUESTION 13

Which one or the following statements about the payback method of investment analysis is correct? The payback method:

- A. Does not consider the time value of money.
- B. Uses discounted cash flow techniques.
- C. Generally leads to the same decision as other methods for long-term projects.
- D. Is rarely used in practice.

Correct Answer: A

Explanation:

Choice "a" is correct. The payback method does not consider the time value of money.

Choice "b" is incorrect. The payback method does not use discounted cash flow techniques. The time value of money is ignored.

Choice "c" is incorrect. The payback method may or may not lead to the same decision as other methods for long-term projects.

Choice "d" is incorrect. The payback method is frequently used in practice because of its simplicity.

QUESTION 14

An auditor most likely would introduce test data into a computerized payroll system to test internal controls related to the:

- A. Existence of unclaimed payroll checks held by supervisors.
- B. Early cashing of payroll checks by employees.
- C. Discovery of invalid employee I.D. numbers.
- D. Proper approval of overtime by supervisors.

Correct Answer: C

Explanation: Choice "c" is correct. Test data allows the auditor to determine whether adequate controls exist over data processing. Test data consists of fictitious entries or inputs that are processed through the client's computer system under the control of the auditor. The client's computerized payroll system should have adequate controls to prevent input of invalid employee ID numbers. Choice "a" is incorrect. This control does not involve the client's computer system and therefore cannot be tested using test data. Choice "b" is incorrect. This control does not involve the client's computer system and therefore cannot be tested using test data. Choice "d" is incorrect. This control does not involve the client's computer system and therefore cannot be tested using test data.

QUESTION 15

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.

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