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QUESTION 1

The information below was taken from the bank transfer schedule prepared during the audit of ABC Co.'s financial statements for the year ended December 31, 20X1. Assume all checks are dated and issued on December 30, 20X1.

<i>Check No.</i>	<u><i>Bank Accounts</i></u>			
	<u><i>From</i></u>	<u><i>To</i></u>		
101	National	Federal		
202	County	State		
303	Federal	American		
404	State	Republic		

<i>Check No.</i>	<u><i>Disbursement Date</i></u>		<u><i>Receipt Date</i></u>	
	<u><i>Per Books</i></u>	<u><i>Per Bank</i></u>	<u><i>Per Books</i></u>	<u><i>Per Bank</i></u>
101	Dec. 30	Jan. 4	Dec. 30	Jan. 3
202	Jan. 3	Jan. 2	Dec. 30	Dec. 31
303	Dec. 31	Jan. 3	Jan. 2	Jan. 2
404	Jan. 2	Jan. 2	Jan. 2	Dec. 31

Which of the following checks illustrate deposits/transfers in transit at December 31, 20X1?

- A. #101 and #202.
- B. #101 and #303.
- C. #202 and #404.
- D. #303 and #404.

Correct Answer: B

Explanation:

Choice "b" is correct. A deposit in transit is a disbursement recorded in one accounting period with the receipt occurring in the subsequent period. Assuming all checks were dated and issued on December 30, 20X1, any deposits with a receipt date in 20X2 would indicate a deposit in transit at December 31, 20X1.

Checks #101 and #303 both meet this criterion and therefore illustrate deposits/transfers in transit at December 31, 20X1.

Choices "a", "c", and "d" are incorrect, based on the above Explanation: .

QUESTION 2

Which of the following statements is true regarding the risk assessment component of internal control?

- A. An auditor evaluates an entity's risk assessment because it is a component of overall audit risk in a financial statement audit.
- B. An auditor's evaluation of an entity's risk assessment may not be applicable to the audit of every entity.
- C. An auditor evaluates an entity's risk assessment to understand how management addresses risks relevant to financial reporting.
- D. An auditor need not consider an entity's risk assessment because he or she is primarily concerned with audit risk in a financial statement audit.

Correct Answer: C

Explanation:

Choice "c" is correct. The auditor needs to understand how management addresses risks relevant to financial reporting in order to properly plan the audit.

Choice "a" is incorrect. An entity's risk assessment differs from an auditor's assessment of audit risk.

The entity is concerned with managing risks that affect entity objectives (financial reporting, operations, and compliance) whereas the auditor is concerned with the risk that material misstatements could occur in the financial statements.

Choice "b" is incorrect. The five components of internal control are applicable to the audit of every entity.

Choice "d" is incorrect. The auditor needs to understand how management addresses risks relevant to financial reporting in order to properly plan the audit.

QUESTION 3

By using the discounted cash flow model, estimate the cost of equity capital for a firm with a stock price of \$30.00, an estimated dividend at the end of the first year of \$3.00 per share, and an expected growth rate of 10 percent.

- A. 21.1 percent.
- B. 12.2 percent.
- C. 11.0 percent.
- D. 20.0 percent.

Correct Answer: D

Explanation:

$$\begin{aligned}K &= \frac{D}{P} + G = \frac{\$3 \text{ Div'd next period}}{\$30 \text{ stock price}} + 10\% \text{ Growth} \\ &= 10\% + 10\% \\ &= 20\% \text{ Cost of Equity Capital}\end{aligned}$$

Choice "d" is correct. 20.0 percent cost of equity capital by using the discounted cash flow model.

QUESTION 4

ABC outlet, a relatively new store, is a cafe that offers customers the opportunity to browse the Internet or play computer games at their tables while they drink coffee. The customer pays a fee based on the amount of time spent signed on to the computer. The store also sells books, tee shirts, and computer accessories. ABC has been paying all of its bills on the last day of the payment period, thus forfeiting all supplier discounts. Shown below are data on ABC's two major vendors, including average monthly purchases and credit terms.

<u>Vendor</u>	<u>Average Monthly Purchases</u>	<u>Credit Terms</u>
Web Master	\$25,000	2/10, net 30
Softidee	50,000	5/10, net 90

Should ABC use trade credit and continue paying at the end of the credit period?

- A. No, if the cost of alternative short-term financing is more.
- B. Yes, if the firm's weighted average cost of capital is equal to its weighted average trade credit.
- C. No, if the cost of alternative long-term financing is more.
- D. Yes, if the cost of alternative short-term financing is more.

Correct Answer: D

Explanation:

Choice "d" is correct. Yes, ABC should use trade credit and continue paying at the end of the credit period, if the cost of alternative short-term financing is more.

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

QUESTION 5

Analytical procedures used in planning an audit should focus on:

- A. Evaluating the adequacy of evidence gathered concerning unusual balances.
- B. Testing individual account balances that depend on accounting estimates.
- C. Enhancing the auditor's understanding of the client's business.
- D. Identifying material weaknesses in internal control.

Correct Answer: C

Explanation: Choice "c" is correct. The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain audit evidence for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (a) enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date, and (b) identifying areas that may represent specific risks relevant to the audit. Choice "a" is incorrect. Analytical procedures to assess the adequacy of evidence would be used in the final review stage. Choice "b" is incorrect. Testing individual account balances that depend on accounting estimates would be a substantive application of analytical procedures and would not be used in the planning stages of an audit. Choice "d" is incorrect. Analytical procedures are generally not useful in detecting material weaknesses in the client's internal control.

QUESTION 6

An extraordinary gain should be reported as a direct increase to which of the following?

- A. Net income.
- B. Comprehensive income.
- C. Income from continuing operations, net of tax.
- D. Income from discontinued operations, net of tax.

Correct Answer: A

Explanation:

Choice "a" is correct. Extraordinary items are reported as a component of net income, after income from continuing operations and discontinued operations.

Choice "b" is incorrect. An extraordinary gain (or loss) only indirectly affects comprehensive income as a component of net income.

Choice "c" is incorrect. Extraordinary items are reported net of tax after income from continuing operations and discontinued operations.

Choice "d" is incorrect. Extraordinary items are reported net of tax after income from continuing operations and discontinued operations.

QUESTION 7

ABC Company's bank requires a compensating balance of 20 percent on a \$100,000 loan. If the stated interest on the loan is 7 percent, what is the effective cost of the loan?

- A. 7.00 percent.
- B. 8.18 percent.
- C. 8.40 percent.
- D. 8.75 percent.

Correct Answer: D

Explanation:

Choice "d" is correct. Total interest for the loan is $\$100,000 \times 7\%$ or \$7,000. The effective amount received is \$80,000 after the 20% compensating balance. The effective interest is $\$7,000 / \$80,000 = 8.75\%$.

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

QUESTION 8

Which of the following best describes an auditor's responsibility with respect to communicating internal control deficiencies of issuers?

- A. The auditor is required to communicate all deficiencies in internal control to management, deficiencies that constitute a significant deficiency to the audit committee, and deficiencies that constitute a material weakness to the full board of directors.
- B. The auditor is required to communicate all deficiencies in internal control to management, and deficiencies that constitute a significant deficiency or a material weakness to management and the audit committee.
- C. The auditor is not required to communicate control deficiencies to management or the audit committee unless they constitute a significant deficiency or a material weakness.
- D. The auditor is not required to communicate control deficiencies or significant deficiencies to management or the audit committee, but must communicate material weaknesses to both management and the audit committee.

Correct Answer: B

Explanation: Choice "b" is correct. The auditor is required to communicate all deficiencies in internal control to management, and deficiencies that constitute a significant deficiency or a material weakness to management and the audit committee. Choice "a" is incorrect. There is no requirement that material weaknesses be communicated to the full board of directors.

Choice "c" is incorrect. The auditor is required to communicate all deficiencies in internal control to management.

Choice "d" is incorrect. The auditor is also required to communicate significant deficiencies to management and the audit committee.

QUESTION 9

Ryan, age 57, is single with no dependents. On July 1, 1997, Ryan's principal residence was sold for the net amount of \$500,000 after all selling expenses. Ryan bought the house in 1963 and occupied it until sold. On the date of sale, the house had a basis of \$180,000. Ryan does not intend to buy another residence. What is the maximum exclusion of gain on sale of the residence that may be claimed in Ryan's 1997 income tax return?

- A. \$320,000
- B. \$250,000
- C. \$125,000
- D. \$0

Correct Answer: B

Explanation:

Choice "b" is correct. \$250,000 maximum exclusion from taxable income.

Rule: An individual may exclude from income up to \$250,000 gain provided that the property was the taxpayer's primary residence for 2 of the last 5 years. Married taxpayers may exclude gains up to \$500,000.

Choice "a" is incorrect. \$320,000. Ryan, age 57, was not married. Thus, his exclusion was limited to \$250,000.

Choice "c" is incorrect. The \$125,000 exclusion was old law and eliminated for sales after 5/6/97.

Choice "d" is incorrect, per the above rule.

QUESTION 10

When the federal government imposes health and safety regulations on certain products, one of the most likely results is:

- A. Greater consumption of the product.
- B. Lower prices for the product.
- C. Higher prices for the product.

D. Increased supply of the product.

Correct Answer: C

Explanation:

Choice "c" is correct. One of the consequences of greater government regulation of certain products is the resulting higher cost to the consumer when the government imposes health and safety regulations on certain products it is likely that expenses will increase and that the added costs will be passed on to consumers in terms of higher prices. The total output for the product may decrease.

Choice "a" is incorrect. Since the price goes up, consumption will decrease.

Choice "b" is incorrect. The price can be expected to increase (see choice "c" above).

Choice "d" is incorrect. Since the price goes up, supply goes down.

QUESTION 11

An accountant had begun to audit the financial statements of a nonissuer. Which of the following circumstances most likely would be considered a reasonable basis for agreeing to the entity's request to change the engagement to a compilation?

- A. The entity's management does not provide the accountant with a signed representation letter.
- B. The accountant is prohibited from corresponding with the entity's legal counsel.
- C. The entity's principal creditors no longer require the entity to furnish audited financial statements.
- D. The accountant is prevented from examining the minutes of the board of directors' meetings.

Correct Answer: C

Explanation: Choice "c" is correct. An audit may be changed to a compilation or review due to a change in client requirements. Since the creditors no longer require audited financial statements, this is a valid reason for requesting a change. Choices "a", "b", and "d" are incorrect. Client-imposed scope limitations, such as refusing to provide a signed representation letter, prohibiting correspondence with legal counsel, or refusing to allow examination of board minutes, are indicative of a lack of cooperation by management. Such limitations would not be a valid basis for changing an engagement from an audit to a compilation.

QUESTION 12

A CPA's report on agreed-upon procedures related to management's assertion about an entity's compliance with specified requirements should contain:

- A. A statement of limitations on the use of the report.
- B. An opinion about whether management's assertion is fairly stated.
- C. Negative assurance that control risk has not been assessed.

D. An acknowledgment of responsibility for the sufficiency of the procedures.

Correct Answer: A

Explanation: Choice "a" is correct. The practitioner's report on agreed-upon procedures related to management's assertion about the entity's compliance with specified requirements is intended solely for the use of specified parties. Thus, the report should include a statement of limitations on the use of the report. Choice "b" is incorrect. The report is in the form of procedures and findings. Since the work performed is less in scope than an examination, the accountant disclaims any opinion. Choice "c" is incorrect. The auditor does not provide any negative assurance relative to assessment of control risk or to compliance with the specified requirements. Choice "d" is incorrect. The report contains a statement that the sufficiency of the procedures is solely the responsibility of the parties specifying the procedures and a disclaimer of responsibility on the part of the accountant.

QUESTION 13

With respect to price elasticity of demand:

- A. The shorter the time period, the more product demand becomes elastic because less choices are available.
- B. Product demand is more elastic when fewer substitutes are available.
- C. Product demand is more inelastic when more substitutes are available.
- D. Product demand is more elastic when more substitutes are available.

Correct Answer: D

Explanation:

Choice "d" is correct. Product demand is more elastic when more substitutes are available.

Choice "a" is incorrect. The longer the time period, the more product demand becomes elastic because more choices are available.

Choice "b" is incorrect. Product demand is more elastic when more substitutes are available, not fewer substitutes.

Choice "c" is incorrect. Product demand is more inelastic when few substitutes are available.

QUESTION 14

An auditor should design the written audit plan so that:

- A. All material transactions will be selected for substantive testing.
- B. Substantive tests prior to the balance sheet date will be minimized.
- C. The audit procedures selected will achieve specific audit objectives.
- D. Each account balance will be tested under either tests of controls or tests of transactions.

Correct Answer: C

Explanation:

Choice "c" is correct. An audit plan aids in instructing assistants in the work to be done. It should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit.

Choice "a" is incorrect. Auditors make extensive use of sampling to perform audit tests. Tests of all material transactions would not be economically feasible.

Choice "b" is incorrect. Assuming that incremental risk can be controlled, substantive tests can be performed prior to year-end.

Choice "d" is incorrect. An account balance does not necessarily have to have tests of controls or tests of transactions applied to it.

QUESTION 15

An entity changed from the straight-line method to the declining balance method of depreciation for all newly acquired assets. This change has no material effect on the current year's financial statements, but is reasonably certain to have a substantial effect in later years. If the change is disclosed in the notes to the financial statements, the auditor should issue a report with a(an):

- A. "Except for" qualified opinion.
- B. Explanatory paragraph.
- C. Unqualified opinion.
- D. Consistency modification.

Correct Answer: C

Explanation: Choice "c" is correct. If an accounting change has no material effect on the financial statements in the current year, but a material future effect, the auditor must ensure that the change is disclosed in the footnotes whenever the financial statements of the change period are presented, but does not have to recognize the change in the current year's audit report. Choice "a" is incorrect. Accounting changes that are accounted for properly do not result in qualified opinions. Choices "b" and "d" are incorrect. A consistency modification (explanatory paragraph) is not necessary when the effect of a change is immaterial.