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QUESTION 1

Which of the following is an advantage of forming a limited liability company (LLC) as opposed to a partnership?

- A. The entity may avoid taxation.
- B. The entity may have any number of owners.
- C. The owner may participate in management while limiting personal liability.
- D. The entity may make disproportionate allocations and distributions to members.

Correct Answer: C

Explanation:

Choice "c" is correct. A member in a limited liability company has limited liability and the ability to manage, while a partner in a general partnership has full liability and the ability to manage.

Choice "a" is incorrect. Generally, both entities' profits are taxable at the ownership level, but a Limited Liability Company may be taxed as an entity if it so elects.

Choice "b" is incorrect. Both entities may have any number of owners.

Choice "d" is incorrect. Both entities may make disproportionate allocations and distributions to their owners.

QUESTION 2

Which of the following sales should be reported as a capital gain?

- A. Sale of equipment.
- B. Real property subdivided and sold by a dealer.
- C. Sale of inventory.
- D. Government bonds sold by an individual investor.

Correct Answer: D

Explanation: Choice "d" is correct. Government bonds held by an individual investor are considered capital assets in the hands of the investor. When these types of security investments are sold, the resulting gain or loss is reported as capital. Choice "a" is incorrect. In this case, we must assume that the BEST answer is option "d" (as that option would ALWAYS result in capital gain or loss treatment) and that the examiners are assuming that the equipment is depreciable equipment that has been used in a business for over one year. [If the equipment had been considered a personal asset by the examiners and had sold for a gain, it would also be a capital asset that sold for a capital gain, and there would be two correct answers. Remember that the correct answer is the option that best answers the question.] Depreciable equipment used in a business and held for over one year falls under the category of Section 1245 property. When Section 1245 assets are sold at a gain, all the accumulated depreciation on the asset is recaptured as ordinary income

(the same category as the depreciation expense was deducted against), and any remaining gain (typically, in practice, this is not the case, though, as the asset would have had to sell for an amount greater than its purchase price) is capital gain under Code Section 1231. [Note that Section 1245 applies only to gains. If the asset had sold for a loss, the loss would have been ordinary under Section 1231.] Choice "b" is incorrect. Real property sold by a dealer is considered inventory and results in ordinary income or ordinary losses upon sale. Inventory is not a capital asset and is not afforded the capital gain benefits. Choice "c" is incorrect. Inventory is not a capital asset and is not afforded the capital gain benefits. The sale of inventory results in ordinary income or loss (e.g., gross profit on sales) being reported on the tax return, as inventory is an asset held for sale in the ordinary course of business.

QUESTION 3

According to the FASB conceptual framework, the objectives of financial reporting for business enterprises are based on:

- A. Generally accepted accounting principles.
- B. Reporting on management's stewardship.
- C. The need for conservatism.
- D. The needs of the users of the information.

Correct Answer: D

Explanation:

Choice "d" is correct. The FASB conceptual framework states that the objectives of financial reporting stem from the informational needs of the external users of the information. SFAC 1 para. 28.

Choice "a" is incorrect. Generally accepted accounting principles (GAAP) are derived from and based on the objectives of financial reporting, not the other way around.

Choice "b" is incorrect. Information concerning management's stewardship is only one aspect of the information financial statements are intended to provide. SFAC 1 para. 50.

Choice "c" is incorrect. Conservatism is an underlying concept for financial accounting but is not the basis for the objectives. SFAC 2 para. 91-97.

QUESTION 4

Heather, Erika, and Shelby are members in ABC LLC. Heather works 40 hours per week and Erika and Shelby work 20 hours per week. Heather contributed \$30,000 to the LLC and Erika and Shelby contributed

\$60,000 each. Erika and Shelby have each originated 45% of the LLC's business and Heather has

originated the other 10%.

If ABC were a general partnership, who controls management?

- A. Heather, because she works the most.
- B. Erika and Shelby equally because they contributed the most.
- C. Heather, Erika, and Shelby equally because of state law.
- D. Erika and Shelby, because they originate most of the work.

Correct Answer: C

Explanation:

Choice "c" is correct.

Rule: Absent an agreement to the contrary, partners have equal management authority.

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

QUESTION 5

Which of the following statements is(are) correct regarding the methods a target corporation may use to ward off a takeover attempt?

I. The target corporation may make an offer ("self-tender") to acquire stock from its own shareholders.

II.

The target corporation may seek an injunction against the acquiring corporation on the grounds that the attempted takeover violates federal antitrust law.

A.

I only.

B.

II only.

C.

Both I and II.

D.

Neither I nor II.

Correct Answer: C

Explanation:

Choice "c" is correct.

Rule: A tender offer is a general invitation by a bidder to the shareholders of a target company to tender their shares to the bidder at a specified price during a specified time. A target of a takeover may ward off a

tender offer by offering to repurchase shares from its shareholders. If a takeover will violate federal antitrust law, a court will enjoin the takeover.

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

QUESTION 6

In 1992, Anchor, Chain, and Hook created ABC Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ABC Associates had profits of \$60,000 that were distributed to the partners. During 1994, ABC Associates was operating at a loss. In September 1994, the partnership dissolved. In October 1994, Hook contracted in writing with XYZ Co. to purchase a car for the partnership. Hook had previously purchased cars from XYZ Co. for use by ABC Associates partners. ABC Associates did not honor the contract with XYZ Co. and XYZ Co. sued the partnership and the individual partners.

A. Anchor's share of ABC Associates' 1993 profits was \$20,000.

B. Hook's share of ABC Associates' 1993 profits was \$30,000.

Correct Answer: B

Explanation:

Choice "b" is correct. Unless otherwise agreed, partners share profits equally. Here, the partners agreed to share profits on the basis of their contributions, which were in a ratio of 1:2:3 respectively for Anchor, Chain, and Hook. Thus, Anchor's share of the 1993 profits was \$10,000, Chain's share was \$20,000, and Hook's share was \$30,000.

QUESTION 7

In which of the following circumstances would an auditor be most likely to express an adverse opinion?

A. The chief executive officer refuses the auditor access to minutes of board of directors' meetings.

B. Tests of controls show that the entity's internal control is so poor that it cannot be relied upon.

C. The financial statements are not in conformity with the FASB Statements regarding the capitalization of leases.

D. Information comes to the auditor's attention that raises substantial doubt about the entity's ability to continue as a going concern.

Correct Answer: C

Explanation:

Choice "c" is correct. An adverse opinion is issued when the financial statements are not presented in accordance with GAAP.

Choice "a" is incorrect. The client's refusal to provide access to the minutes of the Board of Directors' meetings would result in a disclaimer of opinion.

Choice "b" is incorrect. If internal control is so poor that it cannot be relied upon, the auditor must consider the effect on the audit procedures and subsequent report, but would not issue an adverse opinion.

Choice "d" is incorrect. Substantial doubt with regard to the entity's ability to continue as a going concern should be disclosed in an additional explanatory paragraph appended to an otherwise unqualified opinion.

QUESTION 8

For which of the following judgments may an independent auditor share responsibility with an entity's internal auditor who is assessed to be both competent and objective?

	<u>Materiality of misstatements</u>	<u>Evaluation of accounting estimates</u>
A	Yes	No
B	No	Yes
C	No	No
D	Yes	Yes

A. Option A

B. Option B

C. Option C

D. Option D

Correct Answer: C

Explanation:

Choice "c" is correct. Because the auditor has the ultimate responsibility to express an opinion on the financial statements, judgments about assessments of risk, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the auditor.

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

QUESTION 9

Comfort letters ordinarily are:

	<u>Addressed to the client's</u>	<u>Signed by the client's</u>
A	Audit committee	Independent auditor
B	Underwriter of securities	Senior management
C	Audit committee	Senior management
D	Underwriter of securities	Independent auditor

A. Option A

B. Option B

C. Option C

D. Option D

Correct Answer: D

Explanation:

Choice "d" is correct. A comfort letter is a letter from the independent auditor to the named underwriter just before the registration of the client's securities.

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

QUESTION 10

An auditor compared the current-year gross margin with the prior-year gross margin to determine if cost of sales is reasonable. What type of audit procedure was performed?

A. Test of transactions.

B. Analytical procedures.

C. Test of controls.

D. Test of details.

Correct Answer: B

Explanation: Choice "b" is correct. Analytical procedures are evaluations of financial information made by a study of plausible relationships among data, and they include comparisons between current year and prior year financial information. Choice "a" is incorrect. Tests of transactions involve selecting specific transactions and evaluating whether they were properly recorded. Comparing current year and prior year gross margin would not provide information regarding specific transactions. Choice "c" is incorrect. Tests of controls are performed to evaluate the effectiveness of controls. Comparing current year and prior year gross margin would not provide information regarding controls. Choice "d" is incorrect. Test of details are audit procedures used to gather evidence to support specific account balances.

Comparing current year and prior year gross margin does not provide much information regarding specific account balances, although it might identify an account balance worthy of further consideration.

QUESTION 11

Which of the following controls would an entity most likely use in safeguarding against the loss of marketable securities?

- A. An independent trust company that has no direct contact with the employees who have recordkeeping responsibilities has possession of the securities.
- B. The internal auditor verifies the marketable securities in the entity's safe each year on the balance sheet date.
- C. The independent auditor traces all purchases and sales of marketable securities through the subsidiary ledgers to the general ledger.
- D. A designated member of the board of directors controls the securities in a bank safe-deposit box.

Correct Answer: A

Explanation: Choice "a" is correct. The control most likely to be used by an entity in safeguarding against the loss of marketable securities is that an independent trust company that has no direct contact with the employees who have recordkeeping responsibilities, has possession of the securities. For good internal control over the safeguarding of any asset, the individual who has the recordkeeping responsibilities over that asset should never have access to it. Choice "b" is incorrect. Verifying the securities held in the entity's safe would detect that the loss occurred, but it would not prevent the loss. Choice "c" is incorrect. Tracing purchases and sales of marketable securities would verify that the transactions were properly recorded, but would not safeguard against loss. Choice "d" is incorrect. Having one person control the securities in a bank safe-deposit box is a weakness in internal control because that one person can steal the securities. A better system requires that at least two employees have joint control over the securities in a bank safe-deposit box.

QUESTION 12

According to the FASB conceptual framework, an entity's revenue may result from:

- A. A decrease in an asset from primary operations.
- B. An increase in an asset from incidental transactions.
- C. An increase in a liability from incidental transactions.
- D. A decrease in a liability from primary operations.

Correct Answer: D

Explanation:

Rule: Revenues are inflows or other enhancements of assets and/or settlements (decreases) in liabilities resulting from the entity's ongoing major operations, not from "incidental" operations.

Choice "d" is correct. An entity's revenue may result from a decrease in a liability from primary operations.

QUESTION 13

In an audit of an issuer, the auditor must provide an opinion on which of the following?

- I. The financial statements.
 - II. The audit committee's oversight of financial reporting and internal control.
 - III. The effectiveness of internal control.
- A. I and III only.
- B. I, II, and III.
- C. I and II only.
- D. I only.

Correct Answer: A

Explanation:

Choice "a" is correct. The auditor provides an opinion on the entity's financial statements and on the effectiveness of internal control. The auditor is not required to provide an opinion on the audit committee's oversight (but is required to report to the board when such oversight is ineffective).

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

QUESTION 14

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 15

To determine whether accounts payable are complete, an auditor performs a test to verify that all merchandise received is recorded. The population of documents for this test consists of all:

- A. Vendor's invoices.
- B. Purchase orders.
- C. Receiving reports.
- D. Canceled checks.

Correct Answer: C

Explanation:

Choice "c" is correct. The auditor is looking for situations where merchandise has been received but was not recorded. Such situations may be identified by selecting receiving reports and then determining whether the related payable was recorded.

Choice "a" is incorrect. Selecting from vendor's invoices might allow a purchase to be selected for which the goods have not yet been received.

Choice "b" is incorrect. Selecting from purchase orders might allow a purchase to be selected for which the goods have not yet been received.

Choice "d" is incorrect. Selecting from canceled checks will not result in testing of accounts payable, since the payable is eliminated once payment is made.