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





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**QUESTION 1**

In testing long-term investments, an auditor ordinarily would use analytical procedures to ascertain the reasonableness of the:

- A. Completeness of recorded investment income.
- B. Classification between balance sheet portfolios.
- C. Valuation of marketable equity securities.
- D. Existence of unrealized gains or losses in the portfolio.

Correct Answer: A

Explanation: Choice "a" is correct. In testing long-term investments, an auditor ordinarily would use analytical procedures to ascertain the reasonableness of the completeness of recorded investment income. These procedures would probably include a comparison of the recorded investment income with the expected amount (based upon the related interest rate, dividends declared, etc.) and the income balance audited in the prior year. Choice "b" is incorrect. Classification between balance sheet portfolios would most likely be tested by confirming the terms of the investment and making inquiries of management regarding how long they intend to hold the securities. Choice "c" is incorrect. To test the valuation of marketable equity securities an auditor would most likely compare to market quotations (cost method) or examine the audited financial statements of the investee company (equity method). Choice "d" is incorrect. To identify and quantify the existence of unrealized gains and losses in the portfolio, an auditor would examine the trading prices in the Wall Street Journal (or other source) for those long-term investments carried under the cost method. For those carried under the equity method, an auditor would review the audited financial statements of the investee company.

QUESTION 2

Which of the following statements is correct concerning an auditor's required communication of significant deficiencies in internal control noted during an audit of a nonissuer?

- A. A significant deficiency previously communicated during the prior year's audit that remains uncorrected causes a scope limitation.
- B. An auditor should perform tests of controls on significant deficiencies before communicating them to the client.
- C. An auditor's report on significant deficiencies should include a restriction on the distribution of the report.
- D. An auditor should communicate significant deficiencies after tests of controls, but before commencing substantive tests.

Correct Answer: C

Explanation: Choice "c" is correct. The report should state that the communication is intended solely for the use of management, those charged with governance, and others within the organization. Choice "a" is incorrect. Significant deficiencies may represent a conscious decision by management to accept that degree of risk because of cost or other considerations. The auditor may elect to use a primarily substantive approach to test balances, so internal control deficiencies do not necessarily constitute a scope limitation. Choice "b" is incorrect. No requirement to perform tests of controls exists. Significant deficiencies may be identified through the consideration of internal control, the application of audit procedures to balances or transactions, or otherwise during the course of the audit. Choice "d" is incorrect. Significant deficiencies may be communicated during or after the audit.

**QUESTION 3**

Which of the following circumstances most likely would cause an auditor to suspect that material misstatements exist in a client's financial statements?

- A. The assumptions used in developing the prior year's accounting estimates have changed.
- B. Differences between reconciliations of control accounts and subsidiary records are not investigated.
- C. Negative confirmation requests yield fewer responses than in the prior year's audit.
- D. Management consults with another CPA firm about complex accounting matters.

Correct Answer: B

Explanation:

Choice "b" is correct. If control accounts in the general ledger do not reconcile to the subsidiary ledgers, there may be a problem in the way transactions were recorded and posted. Failure to investigate such differences implies that, if such a problem exists, it has not been identified and corrected. The auditor would therefore suspect that material misstatements exist in the client's financial statements.

Choice "a" is incorrect. The assumptions used in developing accounting estimates generally do change as new information becomes available or as situations or conditions change. This would not necessarily indicate that a material misstatement exists.

Choice "c" is incorrect. Since responses to negative confirmations are only received when there are discrepancies, a lower response rate likely would be indicative of fewer problems with accounts receivable. This corresponds to a reduced likelihood of material misstatement.

Choice "d" is incorrect. Management's consultation with another CPA firm about complex accounting matters indicates proactive steps on the part of management to accurately address those matters.

Material misstatements with respect to the complex accounting matters therefore would be less likely to exist.

QUESTION 4

In a competitive labor market, a minimum wage that is set above the equilibrium wage will result in which of the following:

- A. A decrease in the quantity demanded of labor.
- B. An increase in the quantity supplied of labor.



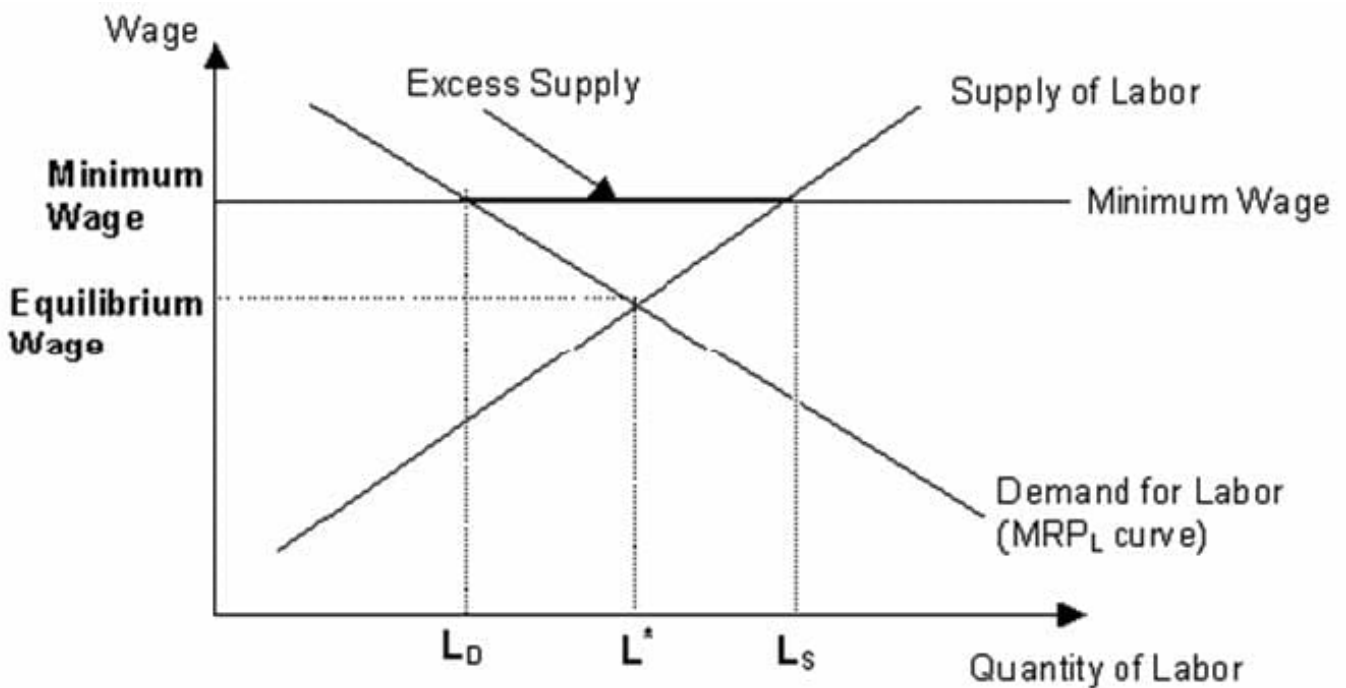
C. A decrease in total employment.

D. All of the above.

Correct Answer: D

Explanation:

Choice "d" is correct. As illustrated in the graph, a minimum wage that is set above the equilibrium wage results in a decrease in the quantity demanded of labor (falls to L_D), an increase in the quantity supplied of labor (increases to L_S), and a decrease in total employment (total employment falls from L^* to L_D).



Choices "a", "b", and "c" are incorrect. All are true, making choice "d" the only right answer.

QUESTION 5

ABC Corp.'s trial balance of Income Statement Accounts for the year ended December 31, 1988 as follows:

	<u>Debit</u>	<u>Credit</u>
Net sales		\$1,600,000
Cost of goods sold	\$960,000	
Selling expenses	235,000	
Administrative expenses	150,000	
Interest expense	25,000	
Hurricane damage	40,000	
Gain on debt extinguishment		10,000
Totals	<u>\$1,410,000</u>	<u>\$1,610,000</u>



ABC's income tax rate is 30%. The gain on debt extinguishment is considered a usual and recurring part of ABC's operations. The hurricane is considered an unusual and infrequent event. ABC prepares a multiple-step income statement for 1988.

Net income is:

- A. \$140,000
- B. \$161,000
- C. \$168,000
- D. \$200,000

Correct Answer: A

Explanation:

Choice "a" is correct. \$140,000.

Net income is the "bottom line" amount after all has been considered on the income statement. Without showing all the line items as required for the income statement, the "bottom line" amount of \$140,000 is derived as follows:

Income from continuing operations	\$240,000
Less: Income taxes (30%)	(72,000)
Extraordinary item - Hurricane damage (net of tax)	<u>(28,000)</u>
Net Income	<u>\$140,000</u>

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