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QUESTION 1

An organization would usually offer credit terms of 2/10, net 30 when:

- A. The organization can borrow funds at a rate less than the annual interest cost.
- B. The cost of capital approaches the prime rate.
- C. Most competitors are not offering discounts, and the organization has a surplus of cash.
- D. Most competitors are offering the same terms, and the organization has a shortage of cash.

Correct Answer: D

Explanation:

Choice "d" is correct. Offering favorable credit terms is usually a response to either competitive forces in the market or to improve cash flow.

Choice "a" is incorrect, although the payment terms of AR is a form of borrowing (or lending) to customers, companies are more likely to extend credit terms because of competitive pressures rather than because it represents a cheaper form of borrowing.

Choice "b" is incorrect. The cost of capital at (or approaching) the prime rate is irrelevant without additional information.

Choice "c" is incorrect. If most competitors are not offering discounts or credit terms, there is no reason to offer them. Also, if there is a surplus of cash, there is no reason to accelerate accounts receivable collection by offering credit terms.

QUESTION 2

Which of the following parties is liable to repay an illegal distribution to a corporation?

- A. A director not breaching his or her duty in approving the distribution and the corporation is solvent.
- B. A director not breaching his or her duty in approving the distribution and the corporation is insolvent.
- C. A shareholder not knowing of the illegality of the distribution and the corporation is solvent.
- D. A shareholder knowing of the illegality of the distribution and the corporation is insolvent.

Correct Answer: D

Explanation:

Choice "d" is correct. Illegal dividends from an insolvent company must be repaid to the corporation for the



benefit of the creditors. A shareholder who knowingly accepts an illegal dividend is liable to return it.

Choices "a" and "b" are incorrect. If a director does not breach any duties in approving a distribution, the director is protected by the business judgment rule and is not liable for the distribution whether the corporation is solvent or insolvent.

Choice "c" is incorrect. A shareholder of a solvent corporation who unknowingly accepts an illegal distribution is not obligated to repay the distribution.

QUESTION 3

When assessing the internal auditors' competence, the independent CPA should obtain information about the:

- A. Organizational level to which the internal auditors report.
- B. Educational background and professional certification of the internal auditors.
- C. Policies prohibiting the internal auditors from auditing areas where relatives are employed.
- D. Internal auditors' access to records and information that is considered sensitive.

Correct Answer: B

Explanation:

Choice "b" is correct. When assessing the internal auditors' competence, the auditor should obtain information about such factors as educational level, experience, professional certification, continuing education, supervision, review, and evaluation of performance.

Choice "a" is incorrect. The organizational level to which the internal auditors report is related to their objectivity.

Choice "c" is incorrect. Policies prohibiting internal auditors from auditing areas where relatives are employed are related to objectivity.

Choice "d" is incorrect. Access to sensitive records and information is related to the overall objectives of the internal audit function, not to internal auditor competence.

QUESTION 4

In order to increase production capacity, ABC Industries is considering replacing an existing production machine with a new technologically improved machine effective January 1, 1997. The following information is being considered by ABC Industries.

-



The new machine would be purchased for \$160,000 in cash. Shipping, installation, and testing would cost an additional \$30,000.

•

The new machine is expected to increase annual sales by 20,000 units at a sales price of \$40 per unit. Incremental operating costs are comprised of \$30 per unit in variable costs and total fixed costs of \$40,000 per year.

•

The investment in the new machine will require an immediate increase in working capital of \$35,000.

•

ABC uses straight-line depreciation for financial reporting and tax reporting purposes. The new machine has an estimated useful life of five years and zero salvage value.

•

ABC is subject to a 40 percent corporate income tax rate.

ABC uses the net present value method to analyze investments and will employ the following factors and rates.

<u>Period</u>	<u>Present Value of \$1 at 10%</u>	<u>Present Value of an Ordinary Annuity of \$1 at 10%</u>
1	.909	.909
2	.826	1.736
3	.751	2.487
4	.683	3.170
5	.621	3.791

ABC Industries\' net cash outflow in a capital budgeting decision would be:

A. \$190,000

B. \$195,000

C. \$204,525

D. \$225,000

Correct Answer: D



Explanation:

Choice "d" is correct. \$225,000 net cash outflow.

Purchase price of new machine	\$ 160,000
Shipping, installation and testing cost	30,000
Required increase in working capital	<u>35,000</u>
Total	<u>\$ 225,000</u>

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

Note: This question is the first from a series of questions on a prior exam. The last in the series is presented for you in the regular homework questions (not the supplemental questions) for this chapter.

QUESTION 5

The work of internal auditors may affect the independent auditor's:

- I. Procedures performed in obtaining an understanding of internal control.
- II. Procedures performed in assessing the risk of material misstatement.
- III.

Substantive procedures performed in gathering direct evidence.

- A.
- I and II only.
- B.
- I and III only.
- C.
- II and III only.
- D.
- I, II, and III.

Correct Answer: D

Explanation:

Choice "d" is correct. The internal auditors' work may affect the nature, timing, and extent of the audit,



including procedures the auditor performs when obtaining an understanding of the entity's internal control, when assessing risk, and when performing substantive procedures.

Choice "a" is incorrect. It is likely that many procedures performed by internal auditors will affect the independent auditor's substantive testing, by providing direct evidence about material misstatements in assertions.

Choice "b" is incorrect. It is likely that the work of internal auditors will aid the independent auditor in assessing control risk, since so much of the internal auditors' function is involved with monitoring the control structure.

Choice "c" is incorrect. It is very likely that the work of internal auditors will affect the independent auditor's procedures for obtaining an understanding of internal control, because monitoring the control system is the primary responsibility of the internal auditors. Their flowcharts, narratives, and analyses of controls could be helpful to the independent auditor.

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