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QUESTION 1

Leker exchanged a van that was used exclusively for business and had an adjusted tax basis of \$20,000 for a new van. The new van had a fair market value of \$10,000, and Leker also received \$3,000 in cash. What was Leker's tax basis in the acquired van?

- A. \$20,000
- B. \$17,000
- C. \$13,000
- D. \$7,000

Correct Answer: B

Explanation:

Choice "b" is correct. \$17,000 is the tax basis in the van.

The basis for like-kind exchanges is computed as follows:

Basis of old property	\$20,000
Less: Boot received	<u>(3,000)</u>
New basis	<u>\$17,000</u>

The general rule is the gain is recognized to the extent boot is received. As the transaction results in a loss to Leker (he received an asset worth \$10,000 plus \$3,000 cash less a \$20,000 tax basis equals \$7,000 loss) no gain is recognized and the \$3,000 received reduces his basis in the new asset. Choice "a" is incorrect. Basis must be reduced by non-like-kind assets (boot) received. Choice "c" is incorrect. For non-like-kind exchanges, the basis would be the FMV of the assets received (\$10,000 FMV plus \$3,000 Boot). However, because both assets have similar use, this is a like-kind exchange, which follows the rule above. Choice "d" is incorrect. The basis of the old property is used to calculate the basis of the new property, less any boot received.

QUESTION 2

Which of the following would not be considered an analytical procedure?

- A. Estimating payroll expense by multiplying the number of employees by the average hourly wage rate and the total hours worked.
- B. Projecting an error rate by comparing the results of a statistical sample with the actual population characteristics.
- C. Computing accounts receivable turnover by dividing credit sales by the average net receivables.
- D. Developing the expected current-year sales based on the sales trend of the prior five years.

Correct Answer: B



Explanation: Choice "b" is correct. Analytical procedures involve comparison of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. Projecting an error rate from a statistical sample does not involve such a comparison. Choice "a" is incorrect. An analytical procedure involves comparison of an independently developed expectation to a recorded amount. Comparing an estimate of payroll expense (developed by multiplying the number of employees by the average hourly rate and the total hours worked) to the recorded expense is an analytical procedure. Choice "c" is incorrect. An analytical procedure involves comparison of an independently developed expectation to a recorded amount. Ratio analysis is often performed in order to compare recorded results to industry norms or to past performance, and therefore calculation of accounts receivable turnover is likely to be an analytical procedure. Choice "d" is incorrect. An analytical procedure involves comparison of an independently developed expectation to a recorded amount. Comparing an estimate of sales (developed based on a trend analysis) to the recorded amount is an analytical procedure.

QUESTION 3

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 4

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 5

The concept of materiality would be least important to an auditor when considering the:

A. Adequacy of disclosure of a client's illegal act.

B. Discovery of weaknesses in a client's internal control.

C. Effects of a direct financial interest in the client on the CPA's independence.

D. Decision whether to use positive or negative confirmations of accounts receivable.

Correct Answer: C

Explanation:

Choice "c" is correct. Any direct financial interest in a client impairs independence, even if it is immaterial.

Choice "a" is incorrect. A material illegal act may require disclosure in or adjustment to the financial statements, whereas an immaterial illegal act may not require disclosure.

Choice "b" is incorrect. A material weakness in internal control will affect the nature, timing, and extent of



audit procedures, whereas an immaterial weakness in internal control may have little impact on the audit.

Choice "d" is incorrect. An auditor is likely to use positive confirmations for material accounts receivable, but may consider negative confirmations for immaterial receivable balances.

QUESTION 6

Adams owns a second residence that is used for both personal and rental purposes. During 2001, Adams used the second residence for 50 days and rented the residence for 200 days. Which of the following statements is correct?

- A. Depreciation may not be deducted on the property under any circumstances.
- B. A rental loss may be deducted if rental-related expenses exceed rental income.
- C. Utilities and maintenance on the property must be divided between personal and rental use.
- D. All mortgage interest and taxes on the property will be deducted to determine the property's net income or loss.

Correct Answer: C

Explanation:

Choice "c" is correct. Because the second property was personally used more than 14 days, any net loss from the rental of the property will be disallowed.

All related expenses must be prorated between the personal use portion and the rental activity portion.

Prorated depreciation is permitted for the rental activity.

QUESTION 7

Frictional unemployment refers to unemployment resulting from:

- A. The skills of workers do not correspond to the skills demanded by employers.
- B. The time needed to match qualified job seekers with available jobs.
- C. Seasonal decreases in demand for labor.
- D. A recession in the economy.

Correct Answer: B

Explanation:

Choice "b" is correct. Frictional unemployment is the unemployment that arises from workers routinely changing jobs or from workers being temporarily laid off. It results from the time needed to match qualified job seekers with available jobs.



Choice "a" is incorrect. This is structural unemployment.

Choice "c" is incorrect. This is seasonal unemployment.

Choice "d" is incorrect. This is cyclical unemployment.

QUESTION 8

Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding:

- A. Disagreements the predecessor had with the client concerning auditing procedures and accounting principles.
- B. The predecessor's evaluation of matters of continuing accounting significance.
- C. The degree of cooperation the predecessor received concerning the inquiry of the client's lawyer.
- D. The predecessor's assessments of inherent risk and judgments about materiality.

Correct Answer: A

Explanation: Choice "a" is correct. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding disagreements the predecessor had with the client concerning auditing procedures and accounting principles. Choice "b" is incorrect. The successor auditor may make specific inquiries of the predecessor auditor regarding the predecessor's evaluation of matters of continuing accounting significance, but this would occur after accepting the engagement. Choice "c" is incorrect. The successor auditor may make specific inquiries of the predecessor auditor regarding the degree of cooperation the predecessor received concerning the inquiry of the client's lawyer, but this would occur after accepting the engagement. Choice "d" is incorrect. The successor auditor would generally come to his or her own conclusions regarding assessments of inherent risk and judgments about materiality without consulting the predecessor auditor.

QUESTION 9

Green, CPA, is requested to render an opinion on the application of accounting principles by an entity that is audited by another CPA. Green may:

- A. Not accept such an engagement because to do so would be considered unethical.
- B. Not accept such an engagement because Green would lack the necessary information on which to base an opinion without conducting an audit.
- C. Accept the engagement but should form an independent opinion without consulting with the continuing CPA.
- D. Accept the engagement but should consult with the continuing CPA to ascertain all the available facts relevant to forming a professional judgment.

Correct Answer: D

Explanation:

Choice "d" is correct. A "reporting accountant" (an accountant in public practice who is requested to render an opinion on the application of GAAP by an entity audited by another CPA) may accept the engagement,



but should consult with the "continuing CPA" to ascertain the available facts relevant to forming a professional judgment.

Choices "a" and "b" are incorrect. A reporting CPA may accept an engagement to render an opinion on GAAP of an entity audited by another CPA. The reporting CPA should consult with the continuing CPA to obtain pertinent information.

Choice "c" is incorrect. The reporting accountant should consult with the continuing accountant to ascertain all the available, relevant facts.

QUESTION 10

With respect to the following matters, which is correct if a general partnership agreement is silent?

- A. A partnership will continue indefinitely unless a majority of the partners votes to dissolve the partnership.
- B. Partnership losses are allocated in the same proportion as partnership profits.
- C. A partner may assign his interest in the partnership but only with the consent of the other partners.
- D. A partner may sell the goodwill of the partnership without the consent of the other partners when the sale is in the best interest of the partnership.

Correct Answer: B

Explanation:

Choice "b" is correct. As a general principle of partnership law, as well as under the Revised Uniform Partnership Act, in the absence of an agreement otherwise partnership losses are allocated among partners in the same proportion as partnership profits.

Choice "a" is incorrect. A partnership will dissolve on the death, bankruptcy, incapacity, or other withdrawal of a partner, unless the partners vote to continue.

Choice "c" is incorrect. A partner may assign his interest in the partnership at any time without consent of the partners since such an assignment does not make the assignee a partner; instead it merely gives the assignee the assignor's rights to distributions from the partnership. Choice "d" is incorrect. A sale of partnership good will is an extraordinary transaction that requires consent of the partners. A single partner has no authority to make such a sale on his own accord.

QUESTION 11

An auditor's responsibility to express an opinion on the financial statements is:

- A. Implicitly represented in the auditor's standard report.



- B. Explicitly represented in the opening paragraph of the auditor's standard report.
- C. Explicitly represented in the scope paragraph of the auditor's standard report.
- D. Explicitly represented in the opinion paragraph of the auditor's standard report.

Correct Answer: B

Explanation:

Choice "b" is correct. The auditor's responsibility to express an opinion on the FS is explicitly represented in the last sentence of the opening paragraph: "Our responsibility is to express an opinion on these financial statements based on our audit."

Choice "a" is incorrect. The responsibility to express an opinion is explicitly represented (i.e., clearly stated), not implicitly represented (i.e., assumed).

Choice "c" is incorrect. There are no words in the scope paragraph that represent an auditor's responsibility to express an opinion.

Choice "d" is incorrect. The opinion paragraph includes the auditor's opinion, but does not specifically mention the auditor's responsibility to express an opinion.

QUESTION 12

Which of the following internal control activities is not usually performed in the vouchers payable department?

- A. Matching the vendor's invoice with the related receiving report.
- B. Approving vouchers for payment by having an authorized employee sign the vouchers.
- C. Indicating the asset and expense accounts to be debited.
- D. Accounting for unused prenumbered purchase orders and receiving reports.

Correct Answer: D

Explanation:

Choice "d" is correct. Accounting for unused prenumbered purchase orders and receiving reports is an effective control, but it would not typically be performed in the vouchers payable department.

Choice "a" is incorrect. Reconciling the vendor invoice with the related receiving report is typically performed by a vouchers payable clerk.

Choice "b" is incorrect. The vouchers payable department is responsible for approving vouchers for payment.



Choice "c" is incorrect. Indicating the asset and expense accounts to be debited is not an internal control procedure.

QUESTION 13

In evaluating the impact of relative inflation rates on the demand for a foreign currency, which of the following is true?

- A. Inflation is irrelevant to currency demand.
- B. As inflation associated with a foreign economy increases in relation to a domestic economy, demand for the foreign currency falls.
- C. As inflation associated with a foreign economy increases in relation to a domestic economy, demand for the foreign currency increases.
- D. As inflation associated with a foreign economy decreases in relation to a domestic economy, demand for the foreign currency falls.

Correct Answer: B

Explanation: Choice "b" is correct. As inflation associated with a foreign currency increases in relation to a domestic economy, demand for the foreign currency falls. Inflation weakens the foreign currency in relation to the domestic currency and makes foreign products more expensive and reduces demand. Reduced demand for a foreign import will reduce the demand for its currency. Choice "a" is incorrect. Inflation, along with interest rates and trade restrictions are significant determinants of exchange rates. Choice "c" is incorrect. As inflation associated with a foreign currency increases in relation to a domestic economy, demand for the foreign currency falls. Inflation weakens the foreign currency in relation to the domestic currency and makes foreign products more expensive and reduces demand. Reduced demand for a foreign import will reduce the demand for its currency, not increase demand. Choice "d" is incorrect. As inflation associated with a foreign currency decreases in relation to a domestic economy, demand for the foreign currency rises. Inflation weakens the domestic currency in relation to the foreign currency and makes foreign products less expensive and increases demand. Increased demand for a foreign import will increase the demand for its currency, not decrease demand.

QUESTION 14

The profitability index is a variation on which of the following capital budgeting models?

- A. Internal rate of return.
- B. Economic value-added.
- C. Net present value.
- D. Discounted payback.

Correct Answer: C

Explanation:

Choice "c" is correct. The profitability index is a variation on the net present value capital budgeting model.

RULE: The profitability index is the ratio of the present value of net future cash inflows to the present value



of the net initial investment. The profitability index is also referred to as the "excess present value index" or simply the "present value index." Companies hope that this ratio will be over 1.0, which means that the present value of the inflows is greater than the present value of the outflows.

$$\frac{\text{Present value of net future cash inflows}}{\text{Present value of net initial investment}} = \text{Profit ability index}$$

Choice "a" is incorrect. The profitability index is a companion computation to net present value, not internal rate of return, which measures percentage return.

Choice "b" is incorrect. The profitability index is a companion computation to net present value, not economic value added.

Choice "d" is incorrect. The profitability index is a companion computation to net present value, not the discounted payback method, which measures years to payback.

QUESTION 15

A successor auditor most likely would make specific inquiries of the predecessor auditor regarding:

- A. Specialized accounting principles of the client's industry.
- B. The competency of the client's internal audit staff.
- C. The uncertainty inherent in applying sampling procedures.
- D. Disagreements with management as to auditing procedures.

Correct Answer: D

Explanation:

Choice "d" is correct. Inquiries should include specific questions regarding, among other things, facts that might bear on the integrity of management; disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters; communications with those charged with governance regarding fraud, illegal acts, and matters relating to internal control; and the predecessor's understanding as to the reasons for the change of auditors.

Choice "a" is incorrect. Specialized industry accounting principles might be discussed; however, the successor would be more likely to inquire about items specific to the client.

Choice "b" is incorrect. The competency of the client's internal audit staff might be discussed; however,



inquiries of the predecessor auditor regarding the staff are not required.

Choice "c" is incorrect. The uncertainty in applying sampling procedures is not something that is typically discussed with the predecessor auditor.

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