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Topic Break Down

Topic	No. of Questions
Topic 1, Auditing and Attestation	502
Topic 2, Business Environment and Concepts	372
Topic 3, Financial Accounting and Reporting	187
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QUESTION NO: 1

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. Payment vouchers.

B. Receiving reports.

C. Purchase requisitions.

D. Vendor's invoices.

ANSWER: B

Explanation:

Receiving reports. is correct because the audit objective is completeness: determining whether liabilities for goods received by year-end have been recorded in accounts payable. Receiving reports are source documents generated when the entity takes delivery and accepts merchandise. They therefore provide a population of items that should lead to a recorded purchase, inventory receipt, and corresponding payable when payment has not yet occurred. The auditor selects receiving reports—particularly reports dated shortly before year-end—and traces them forward to the voucher register, accounts payable records, and financial statements. This direction of testing, from underlying evidence of receipt to the accounting records, is designed to identify received merchandise for which no liability was recorded. It directly addresses the risk that accounts payable and related inventory are understated because a year-end purchase was omitted. Audit evidence should be relevant and reliable for the assertion being tested; internally generated receiving documentation is particularly relevant because it records the event that gives rise to the obligation. The PCAOB's discussion of audit evidence and the relationship of audit procedures to financial-statement assertions is available in PCAOB AS 1105, Audit Evidence. For additional authoritative guidance on designing audit procedures responsive to assessed risks, see PCAOB AS 2301, The Auditor's Responses to the Risks of Material Misstatement.

QUESTION NO: 2

Product demands become more elastic the:

A. Greater the number of substitute products available.

B. Greater the consumer income.

C. Greater the elasticity of supply.

D. Shorter the time period considered.

ANSWER: A

Explanation:

Product demand becomes more elastic as the number of substitute products available increases. Price elasticity of demand measures how responsive the quantity demanded of a product is to a change in its price. When consumers can readily choose among similar products that satisfy the same need, a price increase for one product makes switching to an alternative relatively easy. As a result, the quantity demanded of that product will fall by a larger percentage when its price rises, which is the defining characteristic of more elastic demand.

For example, a consumer facing a higher price for one brand of bottled water, breakfast cereal, or streaming service may move to a comparable brand or service with little difficulty. The availability, closeness, and accessibility of such alternatives therefore increase buyers' ability to respond to price changes. This is a core determinant of price elasticity and is especially important in markets where products are differentiated but fulfill similar consumer purposes. The U.S. Federal Reserve's economics education materials discuss elasticity as the responsiveness of quantity demanded to price changes, and OpenStax identifies the availability of substitutes as a key determinant of demand elasticity. See Federal Reserve Bank of St. Louis: Elasticity of Demand and OpenStax: The Price Elasticity of Demand.

QUESTION NO: 3

Which of the following statements would least likely appear in an auditor's engagement letter?

A. Fees for our services are based on our regular per diem rates, plus travel and other out-of-pocket expenses.

B. During the course of our audit we may observe opportunities for economy in, or improved controls over, your operations.

C. Our engagement is subject to the risk that material errors or fraud, including defalcations, if they exist, will not be detected.

D. After performing our preliminary analytical procedures we will discuss with you the other procedures we consider necessary to complete the engagement.

ANSWER: D

Explanation:

“After performing our preliminary analytical procedures we will discuss with you the other procedures we consider necessary to complete the engagement.” would least likely appear in an audit engagement letter because it inappropriately commits the auditor to discussing the detailed audit procedures to be performed after preliminary analytical procedures. An engagement letter is intended to establish the agreed terms of the engagement at its outset, including the audit’s objective and scope, the responsibilities of management and the auditor, the applicable financial reporting framework, and the expected form and content of reports. Although the auditor communicates relevant matters with management and those charged with governance throughout the audit, the specific nature, timing, and extent of audit procedures are determined through the auditor’s professional judgment and audit planning process. Those procedures may change as the auditor obtains evidence and responds to assessed risks. Accordingly, describing a future consultation with the client about which procedures the auditor considers necessary is not a customary engagement-letter term and could improperly suggest that management participates in determining the auditor’s procedures. The agreed terms of an audit engagement are addressed in AICPA AU-C Section 210; required auditor communications with governance are addressed in PCAOB AS 1301.

QUESTION NO: 4

If an investor's certainty equivalent is greater than the expected value of an investment alternative, the investor is said to be:

A. Risk indifferent.

B. Risk averse.

C. Risk seeking.

D. Cautious.

ANSWER: C

Explanation:

Risk seeking is correct because a certainty equivalent is the certain amount that gives an investor the same utility as a risky investment’s possible outcomes. When the certainty equivalent is greater than the investment’s expected monetary value, the investor values the risky alternative as if it were worth more than its statistical average payoff. Put differently, the investor would accept a certain amount greater than the expected value in exchange for the risky investment, reflecting a preference for the risk itself rather than requiring compensation for bearing it.

This relationship is also expressed through the risk premium, commonly calculated as expected value minus certainty equivalent. Here, that premium is negative because the certainty equivalent exceeds expected value. A negative risk premium is the standard economic indicator of risk-seeking preferences. In expected-utility terms, risk-seeking behavior is associated with a convex utility function over wealth: the utility derived from uncertain outcomes exceeds the utility of receiving their expected value with certainty. This concept is useful in investment and managerial decision-making because it distinguishes a person’s subjective valuation of uncertainty from the investment’s objectively calculated expected payoff. See the Econlib overview of expected utility and the Investopedia definition of certainty equivalent.

QUESTION NO: 5

Tom and Joan Moore, both CPAs, filed a joint 1994 federal income tax return showing $70,000 in taxable income. During 1994, Tom's daughter Laura, age 16, resided with Tom. Laura had no income of her own and was Tom's dependent.

Determine the amount of income or loss, if any that should be included on page one of the Moores' 1994 Form 1040.

In 1994, Joan received $1,300 in unemployment compensation benefits. Her employer made a $100 contribution to the unemployment insurance fund on her behalf.

A. $0

B. $500

C. $900

D. $1,000

E. $1,250

F. $1,300

G. $1,500

H. $2,000 I. $2,500

I. $3,000

J. $10,000 L. $25,000 M. $50,000 N. $55,000

K. $75,000

ANSWER: F

Explanation:

$1,300 is included in the Moores' income. For 1994, unemployment compensation received by an individual was included in gross income in full. Joan actually received $1,300 of unemployment compensation during the year, so the entire amount is reported on page one of the joint Form 1040 as unemployment compensation. The Moores' stated taxable income level does not reduce the amount included; the applicable rule for 1994 did not provide an income-based exclusion for unemployment compensation.

The employer's $100 contribution to the unemployment insurance fund is not an additional payment received by Joan and is not income to her. It is an employer-funded contribution to the insurance arrangement, rather than unemployment compensation paid to the employee. Consequently, it neither increases the $1,300 of reportable unemployment compensation nor creates a separate income item on the return. The proper amount included is therefore the actual unemployment benefit payment of $1,300. The 1994 Form 1040 instructions identify unemployment compensation as an income item reported on the return, and Internal Revenue Code section 85 provides the governing inclusion rule for unemployment compensation in gross income. See the 1994 Form 1040 Instructions and 26 U.S.C. § 85.

QUESTION NO: 6

Stagflation refers to:

A. A combination of rising unemployment and rising real GDP.

B. A combination of rising unemployment and a rising price level.

C. High inflation rates.

D. High unemployment rates.

ANSWER: B

Explanation:

Stagflation is the coexistence of economic stagnation and inflation. It is therefore characterized by rising unemployment together with a rising overall price level. In practical macroeconomic terms, output growth is weak or declining, labor-market conditions deteriorate, and inflation remains elevated. This combination is notable because inflation and unemployment do not usually rise together in the traditional short-run framework; stagnation reduces production and employment while inflation erodes purchasing power.

The term became especially prominent during periods in which adverse supply conditions, such as a sharp increase in energy costs, raised businesses' production costs while also constraining real output. For CPA exam purposes, the key identifying features are unemployment associated with a weak economy and an increasing price level—not merely inflation or unemployment in isolation. The Federal Reserve's discussion of inflation explains that inflation is a sustained increase in the general price level, while the Bureau of Economic Analysis provides the national-accounting measures used to evaluate real output and economic growth. See the Federal Reserve's inflation FAQ and the BEA's GDP data overview.

QUESTION NO: 7

Rich is a cash basis self-employed air-conditioning repairman with 1993 gross business receipts of $20,000. Rich's cash disbursements were as follows:

Yellow Pages listing	2,000
Estimated federal income taxes on self-employment income	1,000
Business long-distance telephone calls	400
Charitable contributions	200

What amount should Rich report as net self-employment income?

A. $15,100

B. $14,900

C. $14,100

D. $13,900

ANSWER: A

Explanation:

$15,100 is Rich's net self-employment income because it is the profit from his repair business after deducting only the ordinary and necessary expenses paid in carrying on that business. Starting with $20,000 of gross business receipts, Rich deducts the $4,900 of allowable business disbursements, producing net business profit of $15,100. For a cash-basis taxpayer, these qualifying expenses are generally deducted when paid, provided they are properly connected with the business and are not capital expenditures.

This calculation is made before personal tax items. In particular, an estimated federal income-tax payment is a personal payment rather than a deductible business expense. Likewise, a charitable contribution made without an expectation of a commensurate business benefit is treated as an individual charitable contribution rather than an expense of operating the repair business. Thus, neither item reduces the business's profit for purposes of reporting net self-employment income. The IRS explains that Schedule C is used to report a sole proprietor's business income and deductible business expenses, resulting in the business's net profit or loss. See the IRS Instructions for Schedule C. The distinction between deductible business expenses and personal expenditures is also addressed in IRS Publication 535, Business Expenses.

QUESTION NO: 8

This question will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment.

Select, as the best answer for each item, the most likely source. Select only one source for each item. The company considers the decline in value of equity securities classified as available-for-sale to be temporary.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.

B. Auditor's communications on significant deficiencies in internal control.

C. Audit inquiry letter to legal counsel.

D. Lawyer's response to audit inquiry letter.

E. Communication from those charged with governance to the auditor.

F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).

G. Report on the application of accounting principles.

H. Auditor's engagement letter.

I. Letter for underwriters.

J. Accounts receivable confirmation request.

K. Request for bank cutoff statement.

L. Explanatory paragraph of an auditor's report on financial statements.

M. Partner's engagement review notes.

N. Management representation letter.

O. Successor auditor's communication with predecessor auditor.

P. Predecessor auditor's communication with successor auditor.

ANSWER: N

Explanation:

The statement belongs in the **Management representation letter**. Whether a decline in the fair value of an investment is temporary is a conclusion that depends substantially on management’s knowledge, intent, expectations, and assessment of relevant facts and circumstances. Management is therefore the appropriate party to make a written representation that it considers the decline temporary. This representation supports the auditor’s evaluation of management’s accounting conclusion, including whether recognition of an impairment or loss is required under the applicable financial reporting framework. It does not replace audit evidence: the auditor still evaluates market information, the magnitude and duration of the decline, the issuer’s financial condition, and other available evidence. However, a written representation documents management’s assertion and provides audit evidence concerning matters that are particularly within management’s knowledge. PCAOB auditing standards describe written representations as confirming management’s responsibilities and representations made to the auditor during the engagement, including representations relevant to financial-statement assertions. See PCAOB AS 2805, Management Representations. The AICPA also explains that management representations are obtained as part of an audit and address information provided to the auditor and management’s responsibilities; see AICPA Auditing Standards.

QUESTION NO: 9

Which one of the following would cause the demand curve for a commodity to shift to the left?

A. A rise in the price of a substitute product.

B. A rise in average household income.

C. A rise in the price of a complementary commodity.

D. A rise in the population.

ANSWER: C

Explanation:

A rise in the price of a complementary commodity shifts the demand curve for the commodity to the left because complementary goods are typically consumed or used together. When the price of one good in the pair increases, consumers generally purchase less of that good and, consequently, less of its complement at every possible price. For example, if gasoline becomes more expensive, the total cost of operating a car rises. Consumers may therefore reduce their planned purchases of cars, shifting the demand curve for cars leftward rather than merely moving to a different point on the existing curve. This is a change in demand caused by a nonprice determinant of demand: the price of a related good. In economic analysis, complements have negative cross-price elasticity of demand, meaning that an increase in the price of one good is associated with a decrease in demand for its complement. A leftward demand shift represents a lower quantity demanded at each price level. The U.S. Federal Reserve's educational material discusses how prices of related goods, including complements, affect demand, and OpenStax provides a detailed explanation of demand shifters and complementary goods. See Federal Reserve Education: Demand and Supply and OpenStax: Shifts in Demand and Supply.

QUESTION NO: 10

An auditor most likely would limit substantive audit tests of sales transactions when control risk is assessed as low for the occurrence assertion concerning sales transactions and the auditor has already gathered evidence supporting:

A. Opening and closing inventory balances.

B. Cash receipts and accounts receivable.

C. Shipping and receiving activities.

D. Cutoffs of sales and purchases.

ANSWER: B

Explanation:

Cash receipts and accounts receivable is correct because this evidence directly supports the occurrence assertion for recorded sales. Occurrence addresses whether sales entered in the accounting records represent genuine transactions with valid customers, rather than fictitious or improperly recorded revenue. Evidence that recorded receivables exist and are subsequently collected in cash provides persuasive corroboration that the underlying sale occurred and that the customer obligation was real. For example, an auditor may confirm accounts receivable with customers, inspect customer responses, and examine subsequent cash receipts by tracing deposits and remittance information to specific outstanding invoices. These procedures connect recorded revenue to an external customer balance and to actual payment, reducing the need for extensive additional substantive testing of individual sales transactions. Because control risk for occurrence has also been assessed as low, the auditor can appropriately reduce substantive testing while still obtaining sufficient appropriate audit evidence. The auditor must nevertheless use professional judgment regarding the nature, timing, and extent of remaining procedures based on the assessed risks. PCAOB guidance discusses accounts-receivable confirmation procedures at PCAOB AU 330 and tailoring audit responses to assessed risks at PCAOB AS 2301.

QUESTION NO: 11

This question will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one source for each item.

Nothing came to our attention that caused us to believe that at October 31, 20XX, there was any change in the capital stock, increase in long-term debt, or decrease in consolidated net current assets or stockholders' equity as compared with the amounts shown in the September 30, 20XX unaudited condensed consolidated balance sheet.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.

B. Auditor's communications on significant deficiencies in internal control.

C. Audit inquiry letter to legal counsel.

D. Lawyer's response to audit inquiry letter.

E. Communication from those charged with governance to the auditor.

F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).

G. Report on the application of accounting principles.

H. Auditor's engagement letter.

I. Letter for underwriters.

J. Accounts receivable confirmation request.

K. Request for bank cutoff statement.

L. Explanatory paragraph of an auditor's report on financial statements.

M. Partner's engagement review notes.

N. Management representation letter.

O. Successor auditor's communication with predecessor auditor.

P. Predecessor auditor's communication with successor auditor.

ANSWER: I

Explanation:

“Letter for underwriters” is the most likely source because the quoted wording is classic negative assurance included in a comfort letter issued by an independent auditor in connection with a securities offering. A comfort letter is addressed to underwriters and helps them perform due diligence regarding financial information included in, or incorporated by reference into, a registration statement or offering document. For a period subsequent to the latest financial statements, the auditor may perform specified procedures, such as reading interim financial information and making inquiries of responsible officials, and report that nothing came to the auditor’s attention indicating specified changes. The statement identifies precisely this form of limited assurance: no change in capital stock, no increase in long-term debt, and no decrease in selected current assets or equity since the date of unaudited interim financial information. This language does not provide an audit opinion on the later date; rather, it communicates the results of limited procedures in the negative-assurance form commonly used in comfort letters. The applicable professional guidance is PCAOB AU 634, Letters for Underwriters and Certain Other Requesting Parties; see also the SEC overview of underwriters in public offerings.

QUESTION NO: 12

ABC Inc. purchases an item on credit with terms of 3/10, net 45. Based on a 360-day year, ABC's annual interest cost of foregoing the cash discount and making payment on the last day of the credit period is:

A. 24.00%

B. 30.86%

C. 31.81%

D. 37.11%

ANSWER: C

Explanation:

31.81% is the annualized cost of declining the supplier’s cash discount. The terms “3/10, net 45” provide a 3% reduction if ABC pays within 10 days; otherwise, the full invoice amount is due on day 45. By not taking the discount, ABC effectively pays 3% more in exchange for using the funds for the additional 35 days between the discount date and the final due date.

The annualized cost is calculated as: discount percentage divided by the amount actually financed, multiplied by the number of 360-day periods in the additional credit period. Thus, the calculation is 3% ÷ 97% × (360 ÷ 35) = 31.81% (rounded). The denominator is 97% rather than 100% because, if the discount is taken, ABC would pay only 97% of the invoice; that is the amount of cash whose payment is deferred. This calculation is a standard short-term financing-cost approximation used in analyzing trade-credit terms. See the discussion of trade credit and cash discounts in OpenStax Principles of Finance and the general financial-management treatment of working-capital financing in CFA Institute's working capital management materials.

QUESTION NO: 13

The permanent file of the audit documentation for an engagement generally would not include:

A. Bond indenture agreements.

B. Lease agreements.

C. Working trial balance.

D. Flowchart of internal control.

ANSWER: C

Explanation:

A working trial balance is correctly excluded from the permanent audit file because it is prepared for, and supports, the audit of a particular reporting period. It typically organizes the current-year account balances, proposed audit adjustments, reclassifications, and links to the detailed schedules and audit evidence used in that year's engagement. Once the audit is completed, its usefulness is primarily tied to that specific period's financial statements and audit conclusions; accordingly, it belongs in the current audit file.

In contrast, a permanent file is intended for documents and information expected to have continuing significance in future audits. Maintaining a clear distinction between permanent and current documentation helps an auditor efficiently plan subsequent engagements and understand matters that persist from period to period. PCAOB auditing standards require audit documentation to provide a clear understanding of the work performed, evidence obtained, and conclusions reached; organizing documentation according to its continuing versus period-specific relevance supports that objective. See PCAOB AS 1215, Audit Documentation. The AICPA's auditing standards resources also describe the professional framework governing audit documentation: AICPA Clarified Statements on Auditing Standards.

QUESTION NO: 14

An example of an indirect cash flow effect would be:

A. Cash committed at inception of the project.

B. Increased payroll expenses due to the project.

C. A depreciation tax shield.

D. An increase in expected future operating cash flows.

ANSWER: C

Explanation:

A depreciation tax shield is an indirect cash flow effect because depreciation itself is a noncash accounting expense: recording it does not require a current-period cash payment. However, depreciation reduces taxable income when it is deductible for tax purposes. That reduction in taxable income lowers cash taxes paid, thereby creating a real incremental cash-flow benefit. In capital-budgeting analysis, the annual tax shield is generally calculated as depreciation expense multiplied by the applicable marginal tax rate. For example, if depreciation is $10,000 and the tax rate is 25%, the project's depreciation deduction produces a $2,500 reduction in taxes, increasing after-tax cash flow by $2,500. This effect is indirect because the cash benefit arises through the tax consequences of an accounting deduction rather than through a direct receipt or disbursement of cash attributable to the asset's purchase or operations. The tax shield should be included in projected operating cash flows for periods in which the depreciation deduction is available and the entity has sufficient taxable income to realize the deduction. The IRS discusses depreciation deductions and their role in determining taxable income in Publication 946, How To Depreciate Property. For the relationship between depreciation, taxes, and cash flows, see the overview of cash-flow reporting in FASB's Accounting Standards Codification resources.

QUESTION NO: 15

In a comparison of 20X2 to 20X1, ABC Co.'s inventory turnover ratio increased substantially although sales and inventory amounts were essentially unchanged. Which of the following statements explains the increased inventory turnover ratio?

A. Cost of goods sold decreased.

B. Accounts receivable turnover increased.

C. Total asset turnover increased.

D. Gross profit percentage decreased.

ANSWER: D

Explanation:

Gross profit percentage decreased. Inventory turnover measures the number of times inventory is sold or used during a period and is generally calculated as cost of goods sold divided by average inventory. Because the inventory amount was essentially unchanged, the denominator did not materially drive the substantial increase in the ratio. Therefore, cost of goods sold must have increased relative to inventory.

Gross profit equals net sales less cost of goods sold, and gross profit percentage is gross profit divided by net sales. With sales essentially unchanged, an increase in cost of goods sold reduces gross profit and, consequently, decreases the gross profit percentage. Thus, a decrease in gross profit percentage is the statement that consistently explains the higher inventory turnover ratio under the facts given. This relationship is a useful analytical link in financial-statement analysis: changes in a margin can identify changes in the cost component underlying turnover ratios. See the SEC's financial reporting guidance on financial statements and the Financial Accounting Standards Board's Accounting Standards Codification for authoritative financial-reporting resources.

QUESTION NO: 16

In obtaining an understanding of an entity's internal control in a financial statement audit, an auditor is not obligated to:

A. Determine whether the control activities have been implemented.

B. Perform procedures to understand the design of internal control.

C. Document the understanding of the entity's internal control components.

D. Search for significant deficiencies in the operation of internal control.

ANSWER: D

Explanation:

“Search for significant deficiencies in the operation of internal control.

” is correct because the objective of obtaining an understanding of internal control is to support the auditor's risk assessment. The auditor obtains sufficient knowledge of the relevant control environment, risk-assessment process, information system, control activities, and monitoring activities to identify and assess risks of material misstatement. This includes evaluating the design of relevant controls and determining whether those controls have been implemented. However, those procedures do not create a separate obligation to conduct a broad or systematic search for operating deficiencies in controls.

Significant deficiencies may come to the auditor's attention while performing risk-assessment procedures, tests of controls, or substantive procedures. When the auditor identifies such a deficiency, auditing standards require appropriate communication to management and those charged with governance. That communication requirement applies to deficiencies identified during the audit; it does not change the scope of the auditor's required understanding procedures into an engagement specifically designed to detect all significant deficiencies. The distinction preserves the risk-based nature of a financial statement audit and recognizes that an audit is not an examination of the effectiveness of every internal control. See PCAOB AS 2110, Identifying and Assessing Risks of Material Misstatement and PCAOB AS 2201, communication of control deficiencies.

QUESTION NO: 17

Which of the following conditions or events most likely would cause an auditor to have substantial doubt about an entity's ability to continue as a going concern?

A. Significant related party transactions are pervasive.

B. Usual trade credit from suppliers is denied.

C. Arrearages in preferred stock dividends are paid.

D. Restrictions on the disposal of principal assets are present.

ANSWER: B

Explanation:

Usual trade credit from suppliers is denied is correct because a loss of normal supplier financing is a direct indicator of possible financial difficulty. Trade credit enables an entity to obtain inventory, materials, or services now and pay under customary terms later. When suppliers no longer extend those customary terms, they may require cash in advance, payment on delivery, or accelerated settlement. This can sharply increase immediate cash needs, disrupt operating cycles, and impair the entity's ability to obtain goods or services needed to generate revenue.

In evaluating going-concern uncertainty, the auditor considers adverse conditions and events, including financial difficulties, and assesses whether they raise substantial doubt about the entity's ability to meet obligations as they become due over the applicable evaluation period. Denial of usual trade credit is specifically recognized in auditing guidance as an example of a condition that may indicate financial difficulty. The auditor would then evaluate management's plans to address the liquidity pressure—such as obtaining alternative financing, negotiating revised supplier terms, or selling assets—and whether those plans are probable of being effectively implemented. See the PCAOB's AS 2415, Consideration of an Entity's Ability to Continue as a Going Concern and the AICPA's auditing standards resources.

QUESTION NO: 18

John and Mary were divorced in 1991. The divorce decree provides that John pay alimony of $10,000 per year, to be reduced by 20% on their child's 18th birthday. During 1992, John paid $7,000 directly to Mary and $3,000 to Spring College for Mary's tuition. What amount of these payments should be reported as income in Mary's 1992 income tax return?

A. $5,600

B. $8,000

C. $8,600

D. $10,000

ANSWER: B

Explanation:

$8,000 should be reported as income by Mary for 1992. Under the law applicable to this 1991 divorce instrument, payments meeting the alimony requirements were includible in the recipient spouse's gross income. The $3,000 paid directly to Spring

College for Mary's tuition is treated as a payment made on Mary's behalf, rather than being excluded merely because John did not remit that portion directly to her. Thus, the full $10,000 paid during the year is considered in determining the alimony amount.

The decree also provides for a 20% reduction in payments when the child reaches age 18. A reduction tied to a child-related contingency fixes that portion as child support for tax purposes. Twenty percent of the annual $10,000 obligation is $2,000, leaving $8,000 characterized as alimony and includible in Mary's 1992 income. The tax treatment in this question reflects the pre-2019 rules governing divorce instruments executed before 2019; the IRS explains the different treatment applicable to post-2018 instruments in Publication 504. The statutory framework for alimony and child-support contingencies is also available at 26 U.S.C. § 71.

QUESTION NO: 19

Using microcomputers in auditing may affect the methods used to review the work of staff assistants because:

A. The audit fieldwork standards for supervision may differ.

B. Documenting the supervisory review may require assistance of consulting services personnel.

C. Supervisory personnel may not have an understanding of the capabilities and limitations of microcomputers.

D. Audit documentation may not contain readily observable details of calculations.

ANSWER: D

Explanation:

"Audit documentation may not contain readily observable details of calculations." is correct because work performed with microcomputers can embed significant audit procedures and calculations in electronic files, spreadsheets, formulas, links, or programmed logic. A printed output or a figure recorded in the audit file may show the result of a calculation without visibly showing the formula, assumptions, source cells, or processing steps used to reach that result. Accordingly, effective supervision and review may require the reviewer to inspect the electronic file itself, evaluate the formulas or logic used, and determine whether the calculation was performed as intended. This is especially important when the computation supports audit evidence or a conclusion in the working papers. Audit documentation must be sufficient to enable an experienced auditor, having no previous connection with the engagement, to understand the work performed, evidence obtained, and conclusions reached. When electronic tools obscure those details in static documentation, the reviewer must use methods that make the underlying work observable and reviewable. The auditor's responsibilities for appropriate direction, supervision, and review remain applicable regardless of whether the work is performed manually or using computerized tools. See the AICPA's AU-C 230 audit-documentation standard and AU-C 220 engagement-quality standard.

QUESTION NO: 20

Which of the following procedures would an auditor most likely perform in auditing the statement of cash flows?

A. Compare the amounts included in the statement of cash flows to similar amounts in the prior year's statement of cash flows.

B. Reconcile the cutoff bank statements to verify the accuracy of the year-end bank balances.

C. Vouch all bank transfers for the last week of the year and first week of the subsequent year.

D. Reconcile the amounts included in the statement of cash flows to the other financial statements' balances and amounts.

ANSWER: D

Explanation:

Reconciling the amounts included in the statement of cash flows to the other financial statements' balances and amounts is the appropriate procedure because the cash flow statement is derived from, and must be consistent with, information reported elsewhere in the financial statements. An auditor traces or reconciles cash provided or used by operating activities to income statement amounts and changes in applicable balance-sheet accounts. The auditor likewise relates investing and financing cash flows to the related noncash asset, debt, equity, and dividend activity reported in the balance sheet, statement of changes in equity, and accompanying records. This work provides audit evidence that the classification, completeness, and mathematical presentation of cash receipts and cash payments agree with the underlying financial-statement information. It also helps the auditor assess whether the ending cash and cash-equivalent balance on the statement of cash flows agrees with the balance sheet and whether significant noncash transactions have been appropriately identified for disclosure. Auditing standards require the auditor to evaluate whether the financial statements are presented in conformity with the applicable reporting framework, including relevant presentation and disclosure matters. See the PCAOB's AS 2810, Evaluating Audit Results and the FASB's overview of Topic 230, Statement of Cash Flows.

QUESTION NO: 21

The method that recognizes the time value of money by discounting the after-tax cash flows over the life of a project, using the company's minimum desired rate of return is the:

A. Accounting rate of return method.

B. Net present value method.

C. Internal rate of return method.

D. Payback method.

ANSWER: B

Explanation:

The **Net present value method.** is correct because it explicitly incorporates the time value of money by converting a project's expected future after-tax cash inflows and outflows into present-value amounts. Each cash flow is discounted using the company's required rate of return, often called its hurdle rate or cost of capital. The resulting net present value equals the present value of expected project cash inflows less the present value of the initial investment and any other applicable cash outflows.

This method directly supports capital-budgeting decisions because the required return is an input selected by the company to reflect its financing costs, risk tolerance, and opportunity cost of capital. A project with a positive net present value is expected to generate a return greater than the required rate and increase the value of the firm; a zero net present value earns exactly the required return. In CPA exam terminology, this is the discounted-cash-flow technique that uses a predetermined minimum desired rate to evaluate project cash flows. The AICPA's CPA Exam blueprint includes capital budgeting and investment-decision concepts within financial management: CPA Exam Blueprints. For the underlying present-value and capital-budgeting framework, see OpenStax: Net Present Value.

QUESTION NO: 22

ABC, Inc. is interested in measuring its overall cost of capital and has gathered the following data. Under the terms described below, the company can sell unlimited amounts of all instruments.

• ABC can raise cash by selling $1,000, 8 percent, 20-year bonds with annual interest payments.

In selling the issue, an average premium of $30 per bond would be received, and the firm must pay floatation costs of $30 per bond. The after-tax cost of funds is estimated to be 4.8 percent.

• ABC can sell 8 percent preferred stock at par value, $105 per share. The cost of issuing and selling the preferred stock is expected to be $5 per share.

• ABC' common stock is currently selling for $100 per share. The firm expects to pay cash dividends of $7 per share next year, and the dividends are expected to remain constant. The stock willhave to be underpriced by $3 per share, and floatation costs are expected to amount to $5 per share.

• ABC expects to have available $100,000 of retained earnings in the coming year; once these retained earnings are exhausted, the firm will use new common stock as the form of common stockequity financing.

• ABC' preferred capital structure is:

Long-term debt 30%

Preferred stock 20 Common stock 50 The cost of funds from the sale of common stock for ABC, Inc. is:

A. 7.0 percent.

B. 7.6 percent.

C. 7.4 percent.

D. 7.8 percent.

ANSWER: B

Explanation:

7.6 percent is the cost of funds from issuing new common stock. Because the expected dividend is constant, the appropriate cost is the perpetuity form of the dividend-growth model: expected annual dividend divided by net proceeds per share. ABC expects to pay $7 per share next year. Although the market price is $100, the company does not receive the full market price when it issues shares: it must underprice the shares by $3 and pay $5 of flotation costs. Therefore, net proceeds are $92 per share ($100 − $3 − $5). The cost of newly issued common equity is consequently $7 ÷ $92 = 0.076087, or approximately 7.6 percent. This is specifically the external common-equity cost, rather than the cost of retained earnings, because the question asks for funds raised through the sale of common stock and explicitly provides both underpricing and flotation costs. In capital-cost calculations, issuance costs reduce the net amount available to the issuer and therefore increase the effective required return on newly issued shares. The constant-dividend valuation relationship underlying this calculation is described in OpenStax's Dividend Discount Model discussion; the role of flotation costs in the cost of new equity is also summarized by Corporate Finance Institute.

QUESTION NO: 23

ABC Cleaning Services is a newly established janitorial firm, and the owner is deciding which type of checking account to open. ABC is planning to keep a $500 minimum balance in the account for emergencies and plans to write an average of 80 checks per month. The bank charges $10 per month plus a $0.10 per check charge for a standard business checking account with no minimum balance.

ABC also has the option of a premium business checking account, which requires a $2,500 minimum balance but has no monthly fees or per check charges. If ABC's cost of funds is 10 percent, which account should ABC choose?

A. Standard account, since the savings is $34 per year.

B. Premium account, since the savings is $34 per year.

C. Standard account, since the savings is $16 per year.

D. Premium account, since the savings is $16 per year.

ANSWER: D

Explanation:

The correct choice is **"Premium account, since the savings is $16 per year."** The standard account's monthly cost is $18: the $10 monthly service charge plus 80 checks multiplied by $0.10, or $8. Annualized, those charges equal $216 ($18 × 12). Although the premium account has no stated banking fees, ABC must hold $2,500 rather than the $500 it already intends to retain for emergencies. Thus, the relevant additional balance tied up is $2,000. Applying ABC's 10% cost of funds to that incremental amount produces an annual opportunity cost of $200 ($2,000 × 10%). This cost represents the return or financing benefit ABC gives up by keeping the additional funds in the premium account instead of using them elsewhere in the business. Comparing the annual amounts, the premium account costs $200 versus $216 for the standard account, yielding annual savings of $16. This analysis follows the capital-budgeting principle that relevant costs include the opportunity cost of cash committed to a decision. See the discussion of opportunity cost in OpenStax Principles of Finance and the Federal Reserve's explanation of the time value of money at Federal Reserve Education.

QUESTION NO: 24

Tom and Joan Moore, both CPAs, filed a joint 1994 federal income tax return showing $70,000 in taxable income. During 1994, Tom's daughter Laura, age 16, resided with Tom. Laura had no income of her own and was Tom's dependent.

Determine the amount of income or loss, if any that should be included on page one of the Moores' 1994 Form 1040.

Tom's 1994 wages were $53,000. In addition, Tom's employer provided group-term life insurance on Tom's life in excess of $50,000. The value of such excess coverage was $2,000.

A. $0

B. $500

C. $900

D. $1,000

E. $1,250

F. $1,300

G. $1,500

H. $2,000

I. $2,500

J. $3,000

K. $10,000

L. $25,000

M. $50,000

N. $55,000

O. $75,000

ANSWER: N

Explanation:

$55,000 is the amount included in gross income on page one of the Moores' 1994 Form 1040 from the facts given. Tom must report his $53,000 of wages as compensation for services. In addition, employer-provided group-term life insurance is generally excludable only up to $50,000 of coverage. When the employer provides coverage above that threshold, the cost of the excess coverage is included in the employee's income. The question expressly states that the value of Tom's excess group-term life insurance coverage is $2,000, so that amount is taxable compensation and is added to his wages. Thus, the income to be included is $53,000 plus $2,000, or $55,000. Laura's dependency status and the couple's stated taxable income do not alter the reporting of Tom's wage income and the taxable value of the excess employer-provided coverage for this calculation. This treatment reflects the longstanding federal income-tax rule for group-term life insurance provided by an employer. See IRS Publication 15-B, Employer's Tax Guide to Fringe Benefits and Internal Revenue Code section 79.

QUESTION NO: 25

Which of the following is not true about accounting estimates?

A. Accounting estimates measure the effects of past transactions or events that cannot be determined in a timely cost-effective manner.

B. Accounting estimates measure the effects of the present status of an asset or liability.

C. An accounting estimate is an approximation of an account pending the outcome of a future event.

D. An accounting estimate is an approximation of past events that can be determined on a timely cost-effective basis.

ANSWER: D

Explanation:

“An accounting estimate is an approximation of past events that can be determined on a timely cost-effective basis.” is not true because the need for an accounting estimate arises when an amount cannot be measured with precision at the reporting date without undue delay or cost. Estimates apply accounting assumptions, methods, and available evidence to derive a reasonable recorded or disclosed amount when direct observation or exact measurement is not practicable. Thus, the defining circumstance is measurement uncertainty or the inability to determine the effect of a transaction or event precisely on a timely, cost-effective basis—not the ability to determine it precisely under those conditions.

For example, management may need to estimate expected credit losses, useful lives and residual values of long-lived assets, warranty obligations, fair values of instruments lacking quoted market prices, or contingent-loss amounts. These amounts reflect conditions existing at the financial statement date, but their measurement often requires judgment about incomplete information, assumptions, or outcomes that are not yet fully known. Auditors evaluate whether management’s methods, assumptions, and data provide a reasonable basis for the resulting estimate. The PCAOB describes accounting estimates as amounts that are subject to measurement uncertainty and require management judgment. See PCAOB Auditing Standard 2501, Auditing Accounting Estimates and FASB Accounting Standards Codification.

QUESTION NO: 26

Which of the following statements describes an auditor's obligation to identify deficiencies in the design or operation of internal control?

A. The auditor should design and apply tests of controls to discover significant deficiencies in internal control that could result in material misstatements.

B. The auditor need not search for significant deficiencies in internal control unless management requests an attestation that "no significant deficiencies in internal control were noted in the audit."

C. The auditor should search for significant deficiencies in internal control if the auditor expects that controls are operating effectively (i.e., if the auditor plans to rely on controls).

D. The auditor need not search for significant deficiencies in internal control but should document and communicate any such deficiencies that are discovered.

ANSWER: D

Explanation:

The auditor need not search for significant deficiencies in internal control but should document and communicate any such deficiencies that are discovered. In a financial statement audit, the auditor obtains an understanding of internal control relevant to the audit and assesses risks of material misstatement. This work may reveal control deficiencies, including significant deficiencies or material weaknesses, but the audit is not an engagement undertaken to identify every control deficiency or to provide assurance that none exist. When the auditor identifies a significant deficiency or material weakness during the audit, professional standards require timely communication to those charged with governance and, as appropriate, management. The communication is ordinarily made in writing and explains the identified matters sufficiently for the recipients to understand their potential significance. Audit documentation should also record the significant professional judgments and evidence supporting the auditor’s conclusions, including identified control deficiencies and the required communications. This approach appropriately distinguishes the auditor’s obligation to evaluate and report deficiencies encountered in performing audit procedures from an obligation to conduct a separate, comprehensive search for them. See AICPA AU-C Section 265, Communicating Internal Control Related Matters Identified in an Audit, and the PCAOB’s AS 1305.

QUESTION NO: 27

In assessing the objectivity of internal auditors, an independent auditor should:

A. Evaluate the quality control program in effect for the internal auditors.

B. Examine documentary evidence of the work performed by the internal auditors.

C. Test a sample of the transactions and balances that the internal auditors examined.

D. Determine the organizational level to which the internal auditors report.

ANSWER: D

Explanation:

Determine the organizational level to which the internal auditors report. This is the appropriate procedure because an internal audit function's objectivity depends substantially on its organizational status and freedom from inappropriate management influence. The independent auditor evaluates whether internal auditors report to a sufficiently high level of authority, such as those charged with governance or senior management with adequate authority, so that the internal audit function can establish broad audit coverage, communicate significant findings, and obtain appropriate consideration and action on its recommendations. A reporting relationship that supports direct, unrestricted communication and protects the internal audit function from responsibility for operational decisions strengthens the likelihood that its work can be performed with the necessary impartiality. Under AU-C 610, the external auditor's assessment of objectivity considers factors such as whether the internal audit function reports to those charged with governance or an officer with appropriate authority, whether it has direct access to those charged with governance, and whether it is free of conflicting responsibilities. This assessment helps the independent auditor decide whether, and to what extent, internal auditors' work may be used in the audit. See the AICPA's clarified auditing standards and the PCAOB's guidance on the auditor's consideration of the internal audit function.

QUESTION NO: 28

The third general standard states that due care is to be exercised in the performance of an audit. This standard is ordinarily interpreted to require:

A. Thorough review of the existing safeguards over access to assets and records.

B. Limited review of the indications of employee fraud and illegal acts.

C. Objective review of the adequacy of the technical training and proficiency of firm personnel.

D. Critical review of the judgment exercised at every level of supervision.

ANSWER: D

Explanation:

The correct requirement is *Critical review of the judgment exercised at every level of supervision.* Due professional care requires auditors to perform their work with the care and skill expected of a prudent auditor and to apply professional judgment throughout the engagement. In practice, this includes appropriate supervision and review: personnel at progressively higher levels assess the work performed, the significant judgments made, and whether audit procedures and conclusions provide an appropriate basis for the auditor's report. Review is not merely an administrative sign-off. It is a substantive quality-control activity that helps ensure important risks, evidence, estimates, and conclusions have received appropriate professional attention.

The historical "third general standard" wording in generally accepted auditing standards explicitly required due professional care in the performance of the audit and preparation of the report. Although the AICPA's clarified auditing standards are now organized differently, the underlying principle remains embedded in the auditor's responsibilities for professional judgment, competence, supervision, and review. A critical review at each supervisory level is therefore the ordinary interpretation most directly tied to exercising due care during an audit. See the AICPA's clarified auditing standards resources and the PCAOB's Due Professional Care in the Performance of Work.

QUESTION NO: 29

An auditor would express an unqualified opinion with an explanatory paragraph added to the auditor's report for:

	An unjustified accounting change	A material weakness in internal control
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A

B. Option B

C. Option C

D. Substantial doubt about the entity's ability to continue as a going concern.

ANSWER: D

Explanation:

Substantial doubt about an entity’s ability to continue as a going concern is the circumstance that supports an unmodified (historically termed “unqualified”) opinion with additional explanatory reporting. The financial statements may still be fairly presented in accordance with the applicable financial reporting framework, so the opinion itself need not be modified. However, when conditions or events raise substantial doubt about the entity’s ability to continue operating for a reasonable period, the auditor must evaluate management’s plans and the adequacy of the related financial-statement disclosures. If the disclosures are adequate, the auditor draws users’ attention to that uncertainty through a separate going-concern section or explanatory paragraph, depending on the reporting standards and terminology applicable to the engagement. This additional communication is important because it highlights a fundamental uncertainty that may significantly affect users’ assessment of the entity’s liquidity, financing needs, and future operations, while preserving an unmodified opinion on fair presentation. The PCAOB’s requirements address the auditor’s consideration and reporting of going-concern uncertainty in AS 2415. Comparable AICPA guidance appears in AU-C section 570.

QUESTION NO: 30

Tracing bills of lading to sales invoices provides evidence that:

A. Shipments to customers were recorded as sales.

B. Recorded sales were shipped.

C. Invoiced sales were shipped.

D. Shipments to customers were invoiced.

ANSWER: D

Explanation:

Tracing bills of lading to sales invoices provides evidence that **shipments to customers were invoiced.** A bill of lading is a shipping document that evidences the release or delivery of goods to a customer. When an auditor begins with those source documents and follows each shipment forward to the related sales invoice, the procedure tests whether the entity’s billing process captured shipments that occurred. This supplies evidence about the completeness of invoicing for recorded shipments and helps the auditor assess whether the entity timely generated invoices for goods sent to customers.

The direction of testing is essential: tracing starts with underlying source documents and follows the transaction into subsequent accounting or billing documentation. Here, the population being tested is shipments documented by bills of lading, and the destination document is the sales invoice. The audit evidence obtained therefore supports the conclusion that the documented customer shipments entered the invoicing process. Auditors select procedures based on the relevant assertion and the direction in which evidence must be followed, consistent with the requirement to obtain sufficient appropriate audit evidence. See the PCAOB's [AS 1105, Audit Evidence] and the AICPA's [AU-C Section 500, Audit Evidence].

QUESTION NO: 31

Which of the following must be included in a company's summary of significant accounting policies in the notes to the financial statements?

A. Description of current year equity transactions.

B. Summary of long-term debt outstanding.

C. Schedule of fixed assets.

D. Revenue recognition policies.

ANSWER: D

Explanation:

Revenue recognition policies must be included because the summary of significant accounting policies communicates the accounting principles and methods that management considers most important to understanding how the entity's financial statements are prepared. Revenue is ordinarily a material financial-statement element, and the timing and method used to recognize it can substantially affect reported revenue, receivables, contract balances, profit, and related disclosures. Accordingly, users need a clear description of the entity's revenue-recognition policy, including the relevant basis for recognizing revenue and any material judgments or methods applied under the applicable reporting framework.

U.S. GAAP requires disclosure of significant accounting policies as an integral part of the financial statements. Revenue-recognition guidance also requires disclosures that provide users with useful information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from customer contracts. Including revenue recognition policies in the policy summary helps meet these objectives by explaining the accounting approach underlying reported amounts. The Financial Accounting Standards Board's revenue topic is available at [FASB Accounting Standards Codification, Revenue from Contracts with Customers]. The Securities and Exchange Commission's financial-reporting guidance and resources are available at [SEC Corporate Finance Financial Reporting Manual resources].

QUESTION NO: 32

Price owns 2,000 shares of ABC Corp.'s $10 cumulative preferred stock. During its first year of operations, cash dividends of $5 per share were declared on the preferred stock but were never paid. In the second year, dividends on the preferred stock were neither declared nor paid. If ABC is dissolved, which of the following statements is correct?

A. ABC will be liable to Price as an unsecured creditor for $10,000.

B. ABC will be liable to Price as a secured creditor for $20,000.

C. Price will have priority over the claims of ABC's bond owners.

D. Price will have priority over the claims of ABC's unsecured judgment creditors.

ANSWER: A

Explanation:

ABC will be liable to Price as an unsecured creditor for $10,000. A dividend declaration creates a corporate obligation to the shareholders entitled to that dividend. Here, the declared but unpaid amount is calculated as 2,000 preferred shares multiplied by the declared cash dividend of $5 per share, or $10,000. Once declared, this amount is no longer merely an anticipated distribution associated with share ownership; it is a debt owed by the corporation to Price.

Because the facts do not provide collateral or a security interest supporting this obligation, Price's claim for the declared dividend is unsecured. On dissolution, the claim is therefore treated with the corporation's unsecured obligations, subject to the applicable liquidation and creditor-priority rules. The cumulative feature protects the preferred shareholder's entitlement to dividends that are properly declared and remain unpaid; it does not change the character of the declared unpaid amount into a secured claim. The relevant accounting distinction is also consistent with the treatment of declared cash dividends as a liability until payment. See the discussion of dividends payable in OpenStax Principles of Financial Accounting and the statutory framework for corporate distributions in the Delaware General Corporation Law.

QUESTION NO: 33

An accountant's standard report issued after compiling the financial statements of a nonissuer should state that:

A. I am not aware of any material modifications that should be made to the accompanying financial statements.

B. A compilation consists principally of inquiries of company personnel and analytical procedures.

C. A compilation is limited to presenting in the form of financial statements information that is the representation of management.

D. A compilation is substantially less in scope than an audit in accordance with GAAS, the objective of which is the expression of an opinion.

ANSWER: C

Explanation:

A compilation is limited to presenting in the form of financial statements information that is the representation of management. This statement correctly describes the fundamental nature of a compilation engagement: the accountant applies accounting and financial-reporting expertise to assist management in presenting its financial information as financial statements, but the underlying information remains management's representation. The accountant does not obtain or provide assurance on that information through audit procedures or review procedures. Therefore, the report must clearly communicate the limited scope of the accountant's work and avoid implying that the accountant has expressed an audit opinion or a review conclusion. Under the current SSARS compilation framework, the accountant's report identifies the engagement as a compilation, states that management is responsible for the financial statements, and explains that no opinion, conclusion, or other form of assurance is provided. The quoted statement captures the key conceptual distinction tested here: a compilation concerns presentation of management-provided financial information rather than assurance on the financial statements. See the AICPA's Compilation and Review Standards resources and the SSARS No. 21 standards material.

QUESTION NO: 34

As a company becomes more conservative with respect to working capital policy, it would tend to have a(n):

A. Increase in the ratio of current liabilities to noncurrent liabilities.

B. Decrease in the operating cycle.

C. Decrease in the quick ratio.

D. Increase in the ratio of current assets to noncurrent assets.

ANSWER: D

Explanation:

An **increase in the ratio of current assets to noncurrent assets** is consistent with a more conservative working-capital policy. A conservative policy emphasizes liquidity and reduces refinancing and cash-shortfall risk by maintaining a relatively larger investment in cash, marketable securities, receivables, and inventory. These current assets provide a greater short-term cushion for meeting obligations as they come due.

Conservatism in working-capital financing also generally means using more stable, long-term financing to support permanent current assets and, potentially, a portion of temporary current assets. Because long-term financing is less subject to immediate repayment or renewal pressure than short-term borrowing, this approach prioritizes financial flexibility and the ability to continue operations during periods of disrupted cash collections, inventory turnover, or credit-market stress.

Accordingly, as a firm adopts a more conservative stance, current assets tend to represent a larger share relative to long-lived, noncurrent assets. This asset mix reflects the firm's willingness to accept potentially lower returns in exchange for stronger liquidity and lower short-term financial risk. The relationship between managing current assets, current liabilities, liquidity, and financing choices is discussed in OpenStax Principles of Finance and the Corporate Finance Institute working-capital overview.

QUESTION NO: 35

ABC Co. changed from the cash basis of accounting to the accrual basis of accounting during 1994. The cumulative effect of this change should be reported in ABC's 1994 financial statements as a:

A. Prior period adjustment resulting from the correction of an error.

B. Prior period adjustment resulting from the change in accounting principle.

C. Component of income before extraordinary item.

D. Component of income after extraordinary item.

ANSWER: A

Explanation:

"Prior period adjustment resulting from the correction of an error." is correct because financial statements prepared under U.S. GAAP are generally required to use the accrual basis of accounting. A company's prior use of the cash basis for GAAP financial reporting is therefore not a permissible election between two GAAP accounting principles. Rather, it represents an error in applying the appropriate accounting framework. The transition to accrual accounting must correct the effects of that error in periods presented.

Under ASC 250, an error correction is accounted for by retrospective restatement of prior-period financial statements, when those statements are presented, and by adjusting the opening balance of retained earnings (or another appropriate net-assets/equity balance) for the earliest period presented. Thus, the cumulative effect is treated as a prior-period adjustment rather than being included in current-year income. The adjustment brings recognition of assets, liabilities, revenues, and expenses into conformity with accrual-based GAAP and ensures that the 1994 results reflect only that year's operations under the proper accounting basis. See the FASB's guidance on accounting changes and error corrections in ASC Topic 250 and the SEC's Financial Reporting Codification section on accounting changes and error corrections.

QUESTION NO: 36

On February 1, 1993, Hall learned that he was bequeathed 500 shares of common stock under his father's will. Hall's father had paid $2,500 for the stock in 1990. Fair market value of the stock on

February 1, 1993, the date of his father's death, was $4,000 and had increased to $5,500 six months later. The executor of the estate elected the alternate valuation date for estate tax purposes. Hall sold the stock for $4,500 on June 1, 1993, the date that the executor distributed the stock to him. How much income should Hall include in his 1993 individual income tax return for the inheritance of the 500 shares of stock, which he received from his father's estate?

A. $5,500

B. $4,000

C. $2,500

D. $0

ANSWER: D

Explanation:

Hall should include $0 in income from the inheritance and sale. Property received by bequest, devise, or inheritance is excluded from a beneficiary's gross income under Internal Revenue Code §102(a). Thus, receiving the 500 shares does not itself create taxable income. See [26 U.S.C. §102].

The later sale is analyzed using the inherited-property basis rules. Generally, inherited property has a basis equal to its value at the decedent's death. However, when the estate's executor validly elects the alternate valuation method, the beneficiary's basis is the value determined under that election. Under the alternate valuation rules, property distributed within six months after death is valued on the distribution date. Hall received and sold the shares on June 1, 1993, before the six-month date, for $4,500. Therefore, the shares' basis is $4,500, and the sale proceeds are also $4,500. The transaction produces neither gain nor loss. The alternate valuation framework is provided in [26 U.S.C. §2032], and the corresponding basis rule is in [26 U.S.C. §1014].

QUESTION NO: 37

ABC Inc. is considering the purchase of a new machine that will cost $150,000. The machine has an estimated useful life of three years. Assume for simplicity that the equipment will be fully depreciated 30, 40, and 30 percent in each of the three years, respectively. The new machine will have a $10,000 resale value at the end of its estimated useful life. The machine is expected to save the company $85,000 per year in operating expenses. ABC uses a 40 percent estimated income tax rate and a 16 percent hurdle rate to evaluate capital projects.

Discount rates for a 16 percent rate are as follows.

	Present Value of $1	Present Value of an Ordinary Annuity of $1
Year 1	.862	.862
Year 2	.743	1.605
Year 3	.641	2.246

What is the net present value of this project?

A. $15,842

B. $13,278

C. $9,432

D. $(35,454)

ANSWER: B

Explanation:

The net present value is **$13,278**. Capital budgeting uses incremental *after-tax* cash flows, discounted at the project's required return. The annual $85,000 operating-cost savings produce after-tax cash savings of $51,000 ($85,000 × 60%). Depreciation is a noncash expense, but it creates a tax shield. Depreciation is $45,000, $60,000, and $45,000 in years one through three, generating tax shields of $18,000, $24,000, and $18,000, respectively, at a 40% tax rate. Thus, annual project cash flows are $69,000, $75,000, and $69,000 before considering disposal proceeds.

Because the equipment is fully depreciated at the end of year three, its $10,000 resale proceeds are fully taxable. The after-tax resale cash flow is therefore $6,000 ($10,000 × 60%), making the year-three total $75,000. Using the 16% present-value factors of 0.8621, 0.7432, and 0.6407, the present values total approximately $163,278: $59,485 + $55,740 + $48,053. Subtracting the initial $150,000 investment yields a positive NPV of $13,278. This approach reflects the standard NPV principle of discounting expected future net cash flows and comparing their present value with the initial outlay. See [OpenStax's NPV method overview] and the [IRS depreciation guidance].

QUESTION NO: 38

Which of the following statements best describes an operating procedure for issuing a new Financial Accounting Standards Board (FASB) statement?

A. The emerging issues task force must approve a discussion memorandum before it is disseminated to the public.

B. The exposure draft is modified per public opinion before issuing the discussion memorandum.

C. A new statement is issued only after a majority vote by the members of the FASB.

D. A new FASB statement can be rescinded by a majority vote of the AICPA membership.

ANSWER: C

Explanation:

A new statement is issued only after a majority vote by the members of the FASB. The FASB is the independent standard-setting body responsible for establishing U.S. GAAP for nongovernmental entities. Its due-process procedures include identifying an issue, conducting research and public outreach, publishing documents for stakeholder feedback when appropriate, and redeliberating the matter after considering the input received. The Board itself ultimately decides whether to issue authoritative guidance; that decision requires approval by a majority of its members. This voting requirement helps ensure that new accounting requirements reflect formal Board action rather than the views of staff, an advisory group, or another professional organization. Although authoritative FASB guidance is now generally issued as an Accounting Standards Update rather than as a standalone FASB Statement, the underlying governance principle tested here remains the same: issuance depends on a majority Board vote. The FASB's standard-setting process and its role in establishing GAAP are described on the FASB Standard-Setting Process page and in the FASB Facts overview.

QUESTION NO: 39

Within the framework of the aggregate demand/aggregate supply model, an increase in short run aggregate supply will cause:

A. Real output to expand and the price level to fall.

B. Real output to decline and the price level to rise.

C. Real output to expand and the price level to rise.

D. Real output to decline and the price level to fall.

ANSWER: A

Explanation:

Real output to expand and the price level to fall is correct. In the aggregate demand/aggregate supply framework, short-run aggregate supply represents the quantity of final goods and services firms will produce at each overall price level when some input costs, particularly nominal wages, are sticky. An increase in short-run aggregate supply shifts the SRAS curve to the right. This can result from reduced input costs, improved productivity, favorable supply conditions, or lower expected production costs.

Holding aggregate demand constant, the new equilibrium occurs where the unchanged aggregate-demand curve intersects the right-shifted SRAS curve. At that intersection, the economy produces a greater real quantity of output and the equilibrium aggregate price level is lower. Thus, the effect is expansion in real output together with a decline in the price level. This is the standard short-run comparative-static result of a positive aggregate supply shock and is distinct from a shift in aggregate demand, which moves output and prices in the same direction. See the Federal Reserve Bank of St. Louis's overview of the aggregate demand–aggregate supply model and OpenStax's discussion of aggregate demand and aggregate supply.

QUESTION NO: 40

Management accountants are frequently asked to analyze various decision situations including the following.

I. The cost of a special device that is necessary if a special order is accepted.

II. The cost proposed annually for the plant service for the grounds at corporate headquarters.

III. Joint production costs incurred, to be considered in a sell-at-split versus a process-further decision.

IV. The costs associated with alternative uses of plant space, to be considered in a make/buy decision.

V. The cost of obsolete inventory acquired several years ago, to be considered in a keep-versus disposal decision.

The costs described in situations I and IV above are:

A. Prime costs.

B. Sunk costs.

C. Discretionary costs.

D. Relevant costs.

E. The cost of a special device that is necessary if a special order is accepted.
II. The cost proposed annually for the plant service for the grounds at corporate headquarters.
III. Joint production costs incurred, to be considered in a sell-at-split versus a process-further decision.
IV. The costs associated with alternative uses of plant space, to be considered in a make/buy decision.

F. The cost of obsolete inventory acquired several years ago, to be considered in a keep-versus disposal decision.
The costs described in situations I and IV above are:

ANSWER: D

Explanation:

Relevant costs are correct because decision-making should focus on future costs and benefits that differ between the available alternatives. The special device required to fulfill a special order is an incremental, avoidable cost: it will be incurred only if management accepts the order. Its amount therefore changes between the accept and reject alternatives and must be included in the analysis.

Likewise, the costs associated with alternative uses of plant space are relevant to a make-or-buy decision. Using available space for internal production can prevent the organization from using that space for another productive purpose. That sacrificed benefit is an opportunity cost, and it differs according to whether the entity makes the item or buys it from an outside supplier. Management accountants include such differential future cash flows and opportunity costs so that the selected alternative reflects the economic effect of committing scarce capacity.

This treatment follows the managerial-accounting principle that relevant information concerns future consequences that vary among alternatives. Further discussion of differential analysis and relevant costs is available in OpenStax Principles of Managerial Accounting and the AICPA & CIMA management accounting resources.

QUESTION NO: 41

An auditor should trace bank transfers for the last part of the audit period and first part of the subsequent period to detect whether:

A. The cash receipts journal was held open for a few days after the year-end.

B. The last checks recorded before the year-end were actually mailed by the year-end.

C. Cash balances were overstated because of kiting.

D. Any unusual payments to or receipts from related parties occurred.

ANSWER: C

Explanation:

Cash balances were overstated because of kiting is correct. A bank-transfer test focuses on transfers recorded near the reporting-date cutoff, tracing both sides of each transfer: the disbursement from the originating bank account and the receipt into the destination bank account. Kiting is a scheme in which a check or transfer is recorded as a deposit in one bank account before it is recorded as a disbursement from another account. This timing difference can cause the same funds to appear in both accounts at the reporting date, overstating total cash.

By examining transfers immediately before and after year-end, the auditor can determine whether the recorded dates, bank-clearing dates, and inclusion in each bank reconciliation are consistent. The auditor commonly compares the dates on the books with bank statement activity and investigates transfers whose receipt and disbursement occur in different accounting periods without a valid timing explanation. This work is particularly important because cash is readily susceptible to misappropriation and cutoff manipulation. The PCAOB identifies reviewing bank transfers around period end as a procedure relevant to detecting potential fraudulent financial reporting involving cash. See PCAOB AU Section 240 and the cash audit guidance in OpenStax's cash-controls discussion.

QUESTION NO: 42

In evaluating the adequacy of the allowance for doubtful accounts, an auditor most likely reviews the entity's aging of receivables to support management's financial statement assertion of:

A. Existence.

B. Valuation and allocation.

C. Completeness.

D. Rights and obligations.

ANSWER: B

Explanation:

Valuation and allocation is correct because the allowance for doubtful accounts is the mechanism management uses to report accounts receivable at the amount expected to be collected, commonly called net realizable value. An aging schedule groups outstanding customer balances by how long they have remained unpaid. As receivables become older, the likelihood of collection generally declines; therefore, aging information provides relevant evidence about whether management's estimated credit-loss allowance is reasonable and whether receivables are appropriately reduced for expected uncollectible amounts at the reporting date.

In auditing this estimate, the auditor considers the aging categories, historical collection and write-off experience, subsequent cash receipts, known financial difficulties of particular customers, disputes, economic conditions, and any changes in credit policies or customer mix. This work addresses whether the reported receivables balance and the related allowance reflect a reasonable estimate of expected collection, which is precisely the valuation aspect of the financial-statement assertions. The PCAOB describes the allowance for credit losses as an accounting estimate requiring audit procedures responsive to estimation uncertainty and relevant data; aging data can be important input data for that evaluation. See PCAOB AS 2501, Auditing Accounting Estimates and FASB ASC Topic 326, Financial Instruments—Credit Losses.

QUESTION NO: 43

Which of the following is not an audit procedure that the independent auditor would perform concerning litigation, claims, and assessments?

A. Obtain assurance from management that it has disclosed all unasserted claims that the lawyer has advised are probable of assertion and must be disclosed.

B. Confirm directly with the client's lawyer that all claims have been recorded in the financial statements.

C. Inquire of and discuss with management the controls adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.

D. Obtain from management a description and evaluation of litigation, claims, and assessments existing at the balance sheet date.

ANSWER: B

Explanation:

“Confirm directly with the client's lawyer that all claims have been recorded in the financial statements” is the procedure the independent auditor would not perform. The auditor’s inquiry of the client’s external legal counsel is designed to corroborate management’s representations about pending or threatened litigation, claims, and assessments and to obtain the lawyer’s evaluation of matters to which the lawyer has devoted substantive attention. It is not a confirmation that management has recorded every claim in the financial statements.

Management, not legal counsel, is responsible for identifying matters requiring accounting or disclosure, assessing them under the applicable financial reporting framework, and preparing the financial statements. The auditor evaluates management’s process and representations, obtains information from management, and ordinarily sends an audit inquiry letter to legal counsel regarding identified matters. Counsel’s response helps the auditor assess the completeness and reasonableness of management’s information, including the likelihood of unfavorable outcomes and the ability to estimate loss where applicable. The auditor therefore cannot shift management’s financial-statement-recording responsibility to the attorney by asking the attorney to certify that all claims were recorded. See PCAOB AS 2505, Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments and AICPA AU-C Section 501.

QUESTION NO: 44

An entity with a large volume of customer remittances by mail could most likely reduce the risk of employee misappropriation of cash by using:

A. Employee fidelity bonds.

B. Independently prepared mailroom prelists.

C. Daily check summaries.

D. A bank lockbox system.

ANSWER: D

Explanation:

A bank lockbox system is the most effective control for an entity receiving a large volume of customer remittances through the mail. Under this arrangement, customers send payments directly to a post office box controlled by the entity’s bank. Bank personnel retrieve the remittances, process them, and deposit the funds directly into the entity’s bank account. The bank then provides the entity with deposit information and remittance details for recording and reconciliation.

This process substantially reduces the opportunity for employees to divert, steal, or delay recording incoming cash because the entity’s employees do not initially receive or handle the customer checks. It also supports segregation of duties: bank processing and deposit activity are independent of the entity’s accounts-receivable recording and reconciliation functions. The entity can use the bank’s deposit reports to reconcile amounts posted to customer accounts with funds deposited, helping identify discrepancies promptly. A lockbox is particularly useful when remittance volume is high because it strengthens control while accelerating collection and deposit of funds. The COSO Internal Control—Integrated Framework emphasizes controls that reduce opportunities for asset misappropriation through appropriate authorization, segregation of duties, and independent information flows. See COSO’s Internal Control guidance and the Federal Reserve’s check services information.

QUESTION NO: 45

An accountant compiles unaudited financial statements that are not expected to be used by a third party. The accountant may decline to issue a compilation report provided:

I. Each page of the financial statements is clearly marked to restrict its use.

II. A written engagement letter is used to document the understanding with the client.III. A written representation letter is obtained from the client's management.

	I	II	III
A.	Yes	No	Yes
B.	Yes	Yes	No
C.	No	No	Yes
D.	No	Yes	No

A. I and III.

B. I and II.

C. I, II, and III.

D. I only.

E. Each page of the financial statements is clearly marked to restrict its use.
II. A written engagement letter is used to document the understanding with the client.III. A written representation letter is obtained from the client's management.

ANSWER: B

Explanation:

Each page of the financial statements is clearly marked to restrict its use and a written engagement letter is used to document the understanding with the client. Under the compilation standards, an accountant may elect not to issue a compilation report when the compiled financial statements are not expected to be used by a third party. This election depends on documenting the terms of the engagement with management in a written engagement letter and placing a clear legend on each page of the financial statements. The legend must state that no assurance is provided and indicate that the statements are intended for management's use only, so that the restricted nature of the statements is evident to any reader.

The engagement letter establishes the accountant's and management's respective responsibilities, including management's responsibility for the financial information and the intended use of the statements. These measures support the report-omission election while still communicating the limited nature and intended use of the compilation. A management representation letter is not a required condition for this type of compilation engagement. The governing requirements are addressed in AICPA Statements on Standards for Accounting and Review Services, particularly AR-C section 80. See the AICPA compilation and review standards resources and the AICPA compilation and review services guidance.

QUESTION NO: 46

When the Economic Order Quantity (EOQ) model is used for a firm, which manufactures its inventory, ordering costs consist primarily of:

A. Insurance and taxes.

B. Storage and handling.

C. Production set-up.

D. Cost of funds.

ANSWER: C

Explanation:

Production set-up. is correct. The EOQ model balances the cost of placing or initiating replenishment against the cost of carrying inventory. For a business that purchases items from outside suppliers, the relevant ordering cost generally includes activities such as preparing purchase orders, receiving goods, inspecting deliveries, and processing supplier invoices. When the company manufactures the inventory itself, however, the comparable replenishment activity is starting a production run. Thus, the primary ordering cost is the production set-up cost: costs incurred to prepare machines, tools, materials, and personnel to manufacture a particular batch.

Set-up activities may include changing tooling or machine configurations, calibrating equipment, scheduling the run, issuing materials to production, and performing initial quality checks. These costs are commonly treated as batch-level costs because they are incurred each time production is initiated, rather than for every individual unit produced. Larger production runs spread a set-up cost over more units but increase average inventory; smaller runs reduce inventory held but require more frequent set-ups. EOQ identifies the order or production quantity that minimizes the combined relevant set-up/order and carrying costs under its assumptions. The U.S. Small Business Administration discusses inventory-control concepts at SBA: Manage inventory, and OpenStax explains inventory management and ordering costs at OpenStax managerial accounting.

QUESTION NO: 47

ABC Industries is the leader in its market for producing high-quality cat food for cats that require special diets. While it has been able to sustain competitive advantage for years, ABC's management has implemented a strategic framework that focuses on why the firm has been so successful in its market.

ABC Industries has implemented which type of strategic framework?

A. Industry structure analysis.

B. Core competencies analysis.

C. Segmentation analysis.

D. None of the above.

ANSWER: B

Explanation:

Core competencies analysis is correct because it examines the distinctive resources, capabilities, knowledge, and activities within an organization that enable it to create and sustain competitive advantage. ABC Industries is not merely assessing its market or the competitive forces affecting the cat-food industry; management is focusing on the internal reasons the company has repeatedly succeeded in serving its specialized market. This framework helps identify the capabilities that are especially valuable to the business, such as specialized nutritional formulation expertise, quality-control processes, research capabilities, trusted veterinary relationships, or a reputation for reliably meeting special dietary needs. Understanding these capabilities helps management protect, strengthen, and apply them to future strategic opportunities.

In strategic-management terminology, core competencies are integrated sets of skills and technologies that support delivery of unique customer value and may be difficult for competitors to replicate. Analyzing them is therefore appropriate when the central question is why a particular organization has achieved enduring success and how it can preserve that advantage. This internal, resource-based perspective aligns directly with ABC Industries' stated objective of determining the source of its sustained performance. See the Mind Tools overview of core competence analysis and the Encyclopaedia Britannica definition of core competence.

QUESTION NO: 48

ABC Co. processes payroll transactions for a retailer. Cook, CPA, is engaged to express an opinion on a description of ABC's internal controls placed in operation as of a specific date. These controls are relevant to the retailer's internal control, so Cook's report may be useful in providing the retailer's independent auditor with information necessary to plan a financial statement audit. Cook's report should:

A. Contain a disclaimer of opinion on the operating effectiveness of ABC's controls.

B. State whether ABC's controls were suitably designed to achieve the retailer's objectives.

C. Identify ABC's controls relevant to specific financial statement assertions.

D. Disclose Cook's assessed level of control risk for ABC.

ANSWER: A

Explanation:

Contain a disclaimer of opinion on the operating effectiveness of ABC's controls. is correct because the engagement described is a service auditor's examination of a service organization's system description and the suitability of the design of controls as of a specified date. This corresponds to a SOC 1 Type 1 report. The service auditor's opinion addresses whether the system description is fairly presented and whether the controls were suitably designed, as of that date, to provide reasonable assurance that the stated control objectives would be achieved if the controls operated effectively.

Because this engagement does not include tests of whether the controls operated effectively over a period of time, the report cannot provide an operating-effectiveness opinion. The report therefore makes clear that no opinion is expressed on operating effectiveness. A user auditor may use the Type 1 report in understanding the service organization's system and in planning the audit, but the report alone does not provide evidence supporting a reduction in assessed control risk based on operating effectiveness.

The distinction between Type 1 and Type 2 SOC 1 reports is described by the AICPA's SOC suite of services overview. Relevant service-organization reporting requirements are contained in SSAE No. 18.

QUESTION NO: 49

Which of the following is not true with respect to the control activities of an entity?

A. Control activities are the policies and procedures that help ensure that management directives are carried out.

B. Control activities are the policies and procedures that help ensure that the financial statements are fairly presented in conformity with generally accepted accounting principles.

C. An understanding of control activities may be obtained while the auditor is obtaining an understanding of the other components of internal control.

D. An understanding of control activities does not require an understanding of control activities related to each account balance included in the financial statements.

ANSWER: B

Explanation:

"Control activities are the policies and procedures that help ensure that the financial statements are fairly presented in conformity with generally accepted accounting principles." is the statement that is not true. Control activities are actions established through policies and procedures to help management carry out directives and mitigate risks to the entity's objectives. Those objectives are broader than external financial reporting under generally accepted accounting principles: they encompass operational objectives, reporting objectives, and compliance objectives. Accordingly, financial-statement fair presentation may be an important outcome supported by particular control activities, but it is not the exclusive purpose or defining scope of all control activities. For example, access controls over inventory can support safeguarding of assets and reliable operational information, while controls over regulatory filings can support compliance. Auditing standards likewise describe control activities as policies and procedures that help ensure management directives are carried out, including controls over risks that may affect relevant financial-statement assertions. The broader internal-control framework is therefore essential when evaluating the nature and purpose of control activities. See the PCAOB's AS 2110, Identifying and Assessing Risks of Material Misstatement and the COSO Internal Control—Integrated Framework guidance.

QUESTION NO: 50

Earnings per share data should be reported on the income statement for:

Extraordinary items	Income before extraordinary items
Yes	No
Yes	Yes
No	Yes
No	No

A. Option A

B. Option B

C. Option C

D. Option D

ANSWER: B

Explanation:

The correct response is the affirmative response for both income before extraordinary items and extraordinary items. Under the historical U.S. GAAP presentation model assumed by this question, earnings per share information was required for income before extraordinary items and for extraordinary items when they were reported. Presenting per-share amounts alongside these components enabled users of the financial statements to distinguish recurring performance from the effect of an unusual, nonrecurring event and to evaluate the event's impact on each common share.

The calculation uses the earnings attributable to common shareholders for the relevant income-statement component and the applicable weighted-average common shares outstanding. Basic EPS and, when applicable, diluted EPS were displayed with the relevant income-statement amounts so that the financial-statement reader could assess both the total earnings effect and the per-share effect. This treatment reflects the former extraordinary-item presentation requirements incorporated in EPS reporting guidance.

For context, extraordinary-item classification was subsequently eliminated from U.S. GAAP by ASU 2015-01. Thus, this answer should be understood as applying to the historical accounting guidance tested by the wording of the question. See the FASB's Accounting Standards Update 2015-01 and PwC's overview of EPS presentation and disclosure.

QUESTION NO: 51

Which of the following is not a required procedure in an engagement to review the interim financial information of a publicly held entity?

A. Obtaining corroborating evidence about the entity's ability to continue as a going concern.

B. Comparing disaggregated revenue data for the current interim period with that of comparable prior periods.

C. Obtaining evidence that the interim financial information reconciles with the accounting records.

D. Inquiring of management about their knowledge of fraud or suspected fraud.

ANSWER: A

Explanation:

Obtaining corroborating evidence about the entity's ability to continue as a going concern is not a required procedure in a review of interim financial information for a publicly held entity. An interim review is substantially narrower in scope than an audit and consists principally of inquiries and analytical procedures. Although the accountant should remain alert to matters that may indicate a substantial doubt about the entity's ability to continue as a going concern, the review standards do not require the accountant to perform separate corroborative procedures designed to evaluate going-concern matters. If information indicating possible going-concern uncertainty comes to the accountant's attention during the review, the accountant considers whether the interim financial information includes appropriate disclosure and communicates with management or the audit committee as applicable. This is consistent with the limited-assurance objective of an interim review: the accountant provides negative assurance based on review procedures rather than obtaining audit-level evidential matter. The PCAOB's interim-review standard identifies inquiries and analytical procedures as the core work of the engagement and addresses the accountant's responsibilities when significant matters arise. See PCAOB AS 4105, Reviews of Interim Financial Information and PCAOB AS 2415, Consideration of an Entity's Ability to Continue as a Going Concern.

QUESTION NO: 52

In auditing a client's retained earnings account, an auditor should determine whether there are any restrictions on retained earnings that result from loans, agreements, or state law. This procedure is designed to corroborate management's financial statement assertions with respect to:

A. Transactions and events.

B. Account balances.

C. Presentation and disclosure.

D. Audit risk and materiality.

ANSWER: C

Explanation:

Presentation and disclosure is correct because restrictions on retained earnings affect how equity information must be communicated in the financial statements and related notes. Loan covenants, contractual agreements, and applicable state laws can limit the amount of retained earnings available for dividend distributions. When a restriction exists, management must appropriately identify or disclose the restricted or appropriated portion of retained earnings so that financial statement users understand the entity's limitations on distributing assets to shareholders.

The auditor's procedure is therefore directed at corroborating whether management has properly classified, described, and disclosed those restrictions. This work supports the presentation-and-disclosure assertions, including that financial statement disclosures are complete, appropriately classified, understandable, and accurately describe the entity's rights and obligations. The audit inquiry is not principally aimed at testing the underlying occurrence of transactions or the measurement of an account balance; it addresses whether the financial statements adequately communicate a significant limitation associated with retained earnings.

AU-C section 315 describes assertions about presentation and disclosure as including appropriate presentation, description, classification, and disclosure of financial information. See AICPA AU-C Section 315 and the SEC's Financial Reporting Manual for financial-reporting guidance and context.

QUESTION NO: 53

ABC, Limited Partnership, was formed by three brothers, Aaron, Barry, and Sam. Aaron is the general partner and devotes more than 60 hours per week to the business. Barry and Sam are limited partners who work for different companies having no relationship to the limited partnership. The partners' capital contributions are as follows: Aaron invested 20%. Barry and Sam invested 40% each.

During the formation of the limited partnership, the brothers signed an agreement that addresses how the brothers will split profits and losses. At year-end, the limited partnership enjoyed large profits due to high demand for the business' product line. The profits will be divided:

A. In proportion to each partner's capital contribution.

B. According to the agreement.

C. Equally.

D. By determining by the amount of time and labor each partner devoted to the operation of the partnership.

ANSWER: B

Explanation:

According to the agreement is correct because the partners expressly entered into an agreement governing the division of profits and losses. A partnership agreement is the primary source for determining the partners' respective economic rights, including the allocation of partnership income. Thus, the agreed allocation applies even though the partners made unequal capital contributions and even though the general partner devotes substantially more time to the business. Capital-contribution percentages and services performed may be relevant facts when an agreement is silent or when determining appropriate terms during formation, but they do not displace a valid agreed-upon profit-sharing provision.

This result also reflects the general partnership-law principle that the partnership agreement governs the relations among partners and the partnership. Default statutory rules apply only to matters not addressed by that agreement. For federal tax purposes, partners may generally agree to allocate partnership items, provided the allocations satisfy the applicable tax-law requirements, including the substantial-economic-effect rules where relevant. The question asks how the partnership's commercial profits will be divided under an agreement that specifically addresses that matter, so the contractual allocation controls. See Cornell Law School's discussion of agreements under uniform-law principles and IRS Publication 541, Partnerships.

QUESTION NO: 54

Which of the following matters is an auditor not required to communicate to those charged with governance?

A. Significant adjustments arising from the audit that were recorded by management.

B. The basis for the auditor's conclusions about the reasonableness of management's sensitive accounting estimates.

C. The level of responsibility assumed by the auditor under generally accepted auditing standards.

D. The degree of reliance the auditor placed on the management representation letter.

ANSWER: D

Explanation:

The degree of reliance the auditor placed on the management representation letter is not a required communication to those charged with governance. A management representation letter is written audit evidence obtained from management and, when appropriate, those charged with governance. The auditor uses it as part of the overall body of evidence in forming the audit opinion. The auditor's internal evaluation of the extent to which that letter supports other audit evidence is an audit-procedure judgment rather than a specified governance communication.

Under AU-C section 260, the required communications are designed to help those charged with governance oversee the financial-reporting process, including the auditor's responsibilities, the planned scope and timing of the audit, and significant findings from the audit. The standards prescribe communication of matters that bear directly on financial reporting, audit oversight, and significant audit judgments. They do not require the auditor to quantify or describe the degree of reliance placed on a particular item of audit evidence, such as management's representation letter. The letter remains important because it documents management's acknowledgements and representations, but the auditor's reliance assessment is not itself a required communication under the governance-communication standard. See the AICPA's Statements on Auditing Standards resources and the AICPA's SAS No. 122 overview.

QUESTION NO: 55

An auditor most likely would introduce test data into a computerized payroll system to test internal controls related to the:

A. Existence of unclaimed payroll checks held by supervisors.

B. Early cashing of payroll checks by employees.

C. Discovery of invalid employee I.D. numbers.

D. Proper approval of overtime by supervisors.

ANSWER: C

Explanation:

Discovery of invalid employee I.D. numbers is correct because test data is a computer-assisted audit technique designed to evaluate whether programmed application controls operate as intended. The auditor prepares fictitious transactions, including deliberately invalid inputs such as an employee identification number that does not exist in the authorized employee master file, and processes them through the client's payroll application. A properly designed and operating input-validation control should identify the invalid number, reject the transaction, or produce an exception report for appropriate follow-up.

This procedure provides direct evidence about the payroll system's automated processing controls, particularly edit checks, validity checks, and master-file matching. The auditor controls the test transactions and knows the expected result in advance, allowing the actual system response to be compared with that expected result. Test data may be processed in a test environment or, if processed in the live environment, must be carefully controlled and reversed so fictitious payroll data does not affect accounting records. The AICPA describes audit data analytics and technology-enabled procedures in its [Audit Data Analytics resources]; the general audit objective of obtaining sufficient appropriate evidence is addressed in [PCAOB AS 1105].

QUESTION NO: 56

A development stage enterprise should use the same generally accepted accounting principles that apply to established operating enterprises for:

	Revenue recognition	Deferral of expenses
A.	Yes	Yes
B.	Yes	No
C.	No	No
D.	No	Yes

A. Recognition of revenues and deferral of expenses.

B. Recognition of revenues, but not deferral of expenses.

C. Deferral of expenses, but not recognition of revenues.

D. Neither recognition of revenues nor deferral of expenses.

ANSWER: A

Explanation:

Recognition of revenues and deferral of expenses is correct. A development-stage enterprise is not permitted to use a separate, less stringent measurement model merely because it has not yet begun normal planned operations or has generated little or no revenue. It applies the same fundamental GAAP recognition and measurement principles as an established operating enterprise. Accordingly, revenue is recognized only when the applicable recognition requirements are satisfied, and costs are deferred only when they qualify for capitalization or another permitted form of deferral under the relevant GAAP guidance. Development-stage status historically affected presentation and disclosure requirements rather than the underlying accounting principles used to recognize revenue or determine whether expenditures should be expensed or deferred. The FASB subsequently removed the former development-stage-entity reporting requirements through

Accounting Standards Update 2014-10, but that change does not create an exception to the ordinary GAAP requirements governing revenue and expenses. The core principle tested is that an entity's stage of operations does not authorize it to accelerate revenue recognition or defer costs that do not meet GAAP criteria. See the FASB's Accounting Standards Codification and Accounting Standards Updates.

QUESTION NO: 57

The ABC Corporation is considering the acquisition of a new machine. The machine can be purchased for $90,000; it will cost $6,000 to transport to ABC's plant and $9,000 to install. It is estimated that the machine will last 10 years, and it is expected to have an estimated salvage value of $5,000. Over its 10-year life, the machine is expected to produce 2,000 units per year with a selling price of $500 and combined material and labor costs of $450 per unit. Federal tax regulations permit machines of this type to be depreciated using the straight-line method over 5 years with no estimated salvage value. ABC has a marginal tax rate of 40 percent.

What is the net cash flow for the tenth year of the project that ABC Corporation should use in a capital budgeting analysis?

A. $81,000

B. $68,400

C. $63,000

D. $60,000

ANSWER: C

Explanation:

$63,000 is the appropriate tenth-year net cash flow. The project produces annual incremental operating cash receipts of $1,000,000, calculated as 2,000 units multiplied by the $500 selling price. Annual cash operating costs are $900,000, or 2,000 units multiplied by $450 for materials and labor. Thus, annual pretax operating income before depreciation is $100,000. Because tax depreciation is permitted only over five years, the machine has no depreciation deduction in year ten. The $100,000 operating amount is therefore taxed at 40%, leaving an after-tax operating cash flow of $60,000.

In the final year, the machine is also sold for its $5,000 salvage value. Its tax basis is zero because the full depreciable cost has been deducted over the five-year tax life. Consequently, the entire $5,000 proceeds amount is taxable, producing tax of $2,000 at the stated marginal rate. After-tax salvage proceeds are therefore $3,000. Adding the $60,000 after-tax operating cash flow and $3,000 after-tax salvage proceeds gives a year-ten cash flow of $63,000. This treatment follows the capital-budgeting principle that terminal cash flows include after-tax disposal proceeds. See the IRS discussion of depreciation and basis in Publication 946 and an overview of relevant property dispositions in Publication 544.

QUESTION NO: 58

ABC, Inc. is a multidivisional corporation, which has both intersegment sales and sales to unaffiliated customers. ABC should report segment financial information for each division meeting which of the following criteria?

A. Segment operating profit or loss is 10% or more of consolidated profit or loss.

B. Segment operating profit or loss is 10% or more of combined operating profit or loss of all company segments.

C. Segment revenue is 10% or more of combined revenue of all the company segments.

D. Segment revenue is 10% or more of consolidated revenue.

ANSWER: C

Explanation:

Segment revenue is 10% or more of combined revenue of all the company segments. Under ASC 280, an operating segment is reportable when it meets any of the quantitative thresholds, one of which is the revenue test. For this test, segment revenue includes both sales to external customers and intersegment sales. The segment's total revenue is then compared with 10% of the combined revenue of all operating segments. This treatment is particularly important for ABC because its divisions generate both external and intersegment revenue; intersegment activity is included in the threshold calculation even though it is eliminated when consolidated financial statements are prepared.

The purpose of segment reporting is to provide financial-statement users with information about material components of an enterprise from the perspective used by management. A division that reaches the revenue threshold has sufficient relative size to warrant separate disclosure, subject to the broader ASC 280 reporting requirements. The same 10% revenue concept is reflected in IFRS segment-reporting guidance, which similarly includes sales to external customers and transactions with other segments in segment revenue. See PwC's ASC 280 reportable-segment guidance and IFRS 8 Operating Segments.

QUESTION NO: 59

Unless the partnership agreement prohibits it, a partner in a general partnership may validly assign rights to:

	Partnership property	Partnership distributions
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A

B. Option B

C. Interest in partnership distributions

D. Option D

ANSWER: C

Explanation:

Interest in partnership distributions is correct because a partner's transferable economic interest is the right to receive the distributions that the partner would otherwise receive from the partnership. A transfer of that interest permits the assignee to receive distributions attributable to the transferred interest, subject to the partnership agreement and applicable partnership law. This is an assignment of an economic right; it does not itself transfer the partner's management authority, agency status, access to partnership property, or status as a partner.

Under the Revised Uniform Partnership Act approach, a partner's transferable interest is limited to the partner's share of profits and losses and the right to receive distributions. The transferee is entitled to receive distributions but does not automatically obtain rights to participate in management or conduct partnership business. This distinction protects the consensual nature of a general partnership while allowing a partner to transfer the financial benefits associated with the partnership interest. See the statutory formulation in California Corporations Code § 16503 and the Uniform Law Commission's Uniform Partnership Act resources.

QUESTION NO: 60

ABC, Inc. is interested in measuring its overall cost of capital and has gathered the following data. Under the terms described below, the company can sell unlimited amounts of all instruments.

• ABC can raise cash by selling $1,000, 8 percent, 20-year bonds with annual interest payments. In selling the issue, an average premium of $30 per bond would be received, and the firm mustpay floatation costs of $30 per bond. The after-tax cost of funds is estimated to be 4.8 percent.

• ABC can sell 8 percent preferred stock at par value, $105 per share. The cost of issuing and selling the preferred stock is expected to be $5 per share.

• ABC' common stock is currently selling for $100 per share. The firm expects to pay cash dividends of $7 per share next year, and the dividends are expected to remain constant. The stock willhave to be underpriced by $3 per share, and floatation costs are expected to amount to $5 per share.

• ABC expects to have available $100,000 of retained earnings in the coming year; once these retained earnings are exhausted, the firm will use new common stock as the form of common stockequity financing.

• ABC' preferred capital structure is:

Long-term debt 30%

Preferred stock 20 Common stock 50

If ABC, Inc. needs a total of $1,000,000, the firm's weighted-average cost of capital would be:

A. 6.8 percent.

B. 4.8 percent.

C. 6.5 percent.

D. 9.1 percent.

ANSWER: A

Explanation:

6.8 percent is the best answer. The weighted-average cost of capital uses the target financing proportions, while recognizing that the available retained earnings are insufficient to supply all of the required common-equity financing. For the $1,000,000 capital requirement, long-term debt represents $300,000, preferred stock represents $200,000, and common equity represents $500,000. Debt contributes 30% × 4.8%, or 1.44%. Preferred stock has annual dividends of $8.40 and net proceeds of $100 per share ($105 less $5 issuance cost), producing an 8.4% cost and a 1.68% weighted contribution.

Of the $500,000 common-equity requirement, $100,000 is retained earnings, whose cost is $7 ÷ $100, or 7%. The remaining $400,000 must be raised through new common stock. Net proceeds are $92 per share after the $3 underpricing and $5 flotation cost, so its cost is $7 ÷ $92, or approximately 7.6%. The weighted common-equity contribution is therefore 10% × 7% plus 40% × 7.6%, approximately 3.74%. Adding the debt, preferred-stock, and common-equity contributions produces approximately 6.86%, reported as 6.8 percent. This treatment follows the standard WACC framework using after-tax debt cost and market-based financing costs; see OpenStax's WACC overview and Corporate Finance Institute's WACC guide.

QUESTION NO: 61

An auditor obtains knowledge about a new client's business and its industry to:

A. Make constructive suggestions concerning improvements to the client's internal control.

B. Develop an attitude of professional skepticism concerning management's financial statement assertions.

C. Evaluate whether the aggregation of known misstatements causes the financial statements taken as a whole to be materially misstated.

D. Understand the events and transactions that may have an effect on the client's financial statements.

ANSWER: D

Explanation:

Understanding the events and transactions that may have an effect on the client's financial statements is correct because knowledge of the entity, its industry, its regulatory environment, and its business model provides the foundation for audit planning and risk assessment. This understanding helps the auditor identify the types of transactions the client enters into, significant accounting practices, economic or industry conditions, and events that could create risks of material misstatement in account balances, disclosures, or financial-statement assertions. For a new client, this work is especially important because the auditor has not developed knowledge through prior-year audits.

Audit standards require the auditor to obtain an understanding of the entity and its environment sufficient to identify and assess risks of material misstatement. The auditor uses that knowledge to determine where misstatements may arise and to design audit procedures that respond appropriately to the assessed risks. For example, understanding a client's revenue sources, supply-chain arrangements, financing activities, or industry-specific regulation may reveal transactions or events requiring particular audit attention. See the PCAOB's AS 2110, Identifying and Assessing Risks of Material Misstatement and the AICPA's AU-C Section 315.

QUESTION NO: 62

ABC Co. is considering the acquisition of a new, more efficient press. The cost of the press is $360,000, and the press has an estimated six-year life with zero salvage value. ABC uses straightline depreciation for both financial reporting and income tax reporting purposes and has a 40 percent corporate income tax rate. In evaluating equipment acquisitions of this type, ABC uses a goal of a four-year payback period. To meet ABC's desired payback period, the press must produce a minimum annual before-tax, operating cash savings of:

A. $90,000

B. $110,000

C. $114,000

D. $150,000

ANSWER: B

Explanation:

$110,000 is the minimum annual before-tax operating cash savings required. A four-year payback on the $360,000 investment requires annual after-tax cash inflows of $90,000 ($360,000 ÷ 4). Because the press has a six-year life and no salvage value, straight-line depreciation is $60,000 per year ($360,000 ÷ 6). Depreciation is not itself an operating cash flow, but it reduces taxable income and therefore generates an annual tax shield of $24,000 ($60,000 × 40%).

Let annual before-tax operating cash savings equal B. The associated annual after-tax operating cash flow consists of the after-tax portion of the savings plus the depreciation tax shield: B × (1 − 0.40) + ($60,000 × 0.40). Setting that amount equal to the required $90,000 annual after-tax inflow gives 0.60B + $24,000 = $90,000. Thus, 0.60B = $66,000 and B = $110,000. This amount produces exactly the after-tax annual cash flow needed to recover the initial investment within four years. Straight-line depreciation is based on allocating the depreciable basis evenly over the asset's useful life, consistent with the stated facts. See the IRS discussion of depreciation methods in Publication 946 and the capital-budgeting overview from OpenStax Principles of Finance.

QUESTION NO: 63

Which of the following questions would an auditor most likely include on an internal control questionnaire for notes payable?

A. Are assets that collateralize notes payable critically needed for the entity's continued existence?

B. Are two or more authorized signatures required on checks that repay notes payable?

C. Are the proceeds from notes payable used for the purchase of noncurrent assets?

D. Are direct borrowings on notes payable authorized by the board of directors?

ANSWER: D

Explanation:

“Are direct borrowings on notes payable authorized by the board of directors?

” is the appropriate internal-control questionnaire item because entering into debt is a significant financing transaction that can create substantial obligations, interest costs, repayment requirements, and restrictions on the entity. A sound control system assigns approval of such transactions to personnel or a governing body with appropriate authority. For direct borrowings, board authorization provides evidence that management cannot independently incur material debt outside established governance and financing policies.

An auditor obtains an understanding of controls relevant to financial reporting, including controls over the authorization of significant transactions. Asking whether the board authorizes direct borrowings helps the auditor assess whether notes payable are initiated only after proper approval and whether recorded debt is likely to represent valid, authorized obligations of the entity. The response also helps identify the expected documentary evidence, such as board minutes, borrowing resolutions, and executed loan agreements, that may be inspected during audit procedures. The PCAOB describes authorization as a relevant control activity and requires auditors to understand and evaluate controls over significant accounts and disclosures; notes payable commonly represent such an account. See PCAOB Auditing Standard 2201 and COSO Internal Control guidance.

QUESTION NO: 64

An auditor testing long-term investments would ordinarily use analytical review as the primary audit procedure to ascertain the reasonableness of the:

A. Valuation of marketable equity securities.

B. Classification of gains and losses on the disposal of securities.

C. Completeness of recorded investment income.

D. Existence and ownership of investments.

ANSWER: C

Explanation:

Completeness of recorded investment income is correct because analytical procedures are particularly well suited to assessing whether the return reported from an investment portfolio is plausible in relation to the investments held. The auditor can develop an independent expectation by using average investment balances, stated coupon or dividend rates, market yields, dates of acquisition or disposition, and prior-period results. Comparing that expectation with recorded interest income, dividend income, and related accruals can identify unexplained fluctuations or amounts that appear incomplete. For example, if the entity held interest-bearing investments throughout the year, a yield analysis can indicate the approximate income that should have been recognized; a material shortfall warrants further audit work. This approach provides evidence about the reasonableness of the recorded income population and helps direct attention to omitted receipts or unrecorded accruals. Auditing standards describe analytical procedures as evaluations of plausible relationships among financial and nonfinancial data, including comparisons to auditor-developed expectations. The AICPA’s audit guide and standards resources discuss using these procedures in substantive testing: AICPA Audit and Assurance Standards. The PCAOB likewise defines analytical procedures as evaluations of financial information through analysis of plausible relationships: PCAOB AU 329, Substantive Analytical Procedures.

QUESTION NO: 65

Which of the following is a requirement for a small business corporation to elect S corporation status?

A. It has only one class of stock.

B. It has at least one partnership as a shareholder.

C. It has international ownership.

D. It has more than 75 shareholders.

ANSWER: A

Explanation:

It has only one class of stock. A corporation qualifies as a “small business corporation” eligible to elect S corporation treatment only if it satisfies the requirements in Internal Revenue Code § 1361. One of those express requirements is that it have no more than one class of stock. For this purpose, the focus is generally on the corporation’s economic rights: all outstanding shares must provide identical rights to distributions and liquidation proceeds. The corporation may have differences in voting rights, such as voting and nonvoting common shares, without necessarily creating a prohibited second class of stock, provided those economic rights remain identical.

This requirement helps preserve the intended pass-through structure of an S corporation by preventing the use of preferred economic arrangements that would allocate corporate earnings or liquidation value differently among shareholders. The election is made by filing Form 2553, but the entity must first meet the statutory eligibility conditions, including the one-class-of-stock rule. The governing statutory definition is available at 26 U.S.C. § 1361. The IRS also summarizes S corporation eligibility and election procedures at IRS: S Corporations.

QUESTION NO: 66

When communicating internal control related matters noted in an audit of a nonissuer, an auditor's report issued on significant deficiencies should indicate that:

A. Errors or fraud may occur and not be detected because there are inherent limitations in any internal control.

B. The issuance of an unqualified opinion on the financial statements may be dependent on corrective follow-up action.

C. A material weakness exists when the deficiencies noted were not detected within a timely period by employees in the normal course of performing their assigned functions.

D. The purpose of the audit was to report on the financial statements and not to provide assurance on internal control.

ANSWER: D

Explanation:

The purpose of the audit was to report on the financial statements and not to provide assurance on internal control. This wording is required in a written communication of significant deficiencies or material weaknesses identified during an audit of a nonissuer’s financial statements. The audit is planned and performed to obtain reasonable assurance that the financial statements are free of material misstatement, rather than to express an opinion on the effectiveness of internal control. Accordingly, the auditor’s internal-control communication must clarify its limited purpose and avoid implying that the auditor performed an engagement designed to provide assurance on internal control.

Under AU-C section 265, the auditor communicates significant deficiencies and material weaknesses identified during the audit to management and those charged with governance. The communication explains that the auditor considered internal control only to design audit procedures appropriate for the circumstances. It also states that this consideration was not undertaken to express an opinion on the effectiveness of internal control. This context helps financial-statement users and governance personnel correctly understand the nature, scope, and limitations of the communication. See AICPA AU-C section 265 and the PCAOB’s internal-control audit guidance.

QUESTION NO: 67

The amount of inventory that a company would tend to hold in stock would increase as the:

A. Cost of carrying inventory decreases.

B. Variability of sales decreases.

C. Cost of running out of stock decreases.

D. Length of time that goods are in transit decreases.

ANSWER: A

Explanation:

Cost of carrying inventory decreases. Carrying costs are the costs incurred by keeping inventory on hand over time, including storage, insurance, handling, deterioration or obsolescence risk, and the opportunity cost of capital invested in goods. When these costs fall, the economic penalty for holding additional units is lower. A company can therefore economically choose larger replenishment quantities and/or maintain more inventory between deliveries, increasing its average inventory balance.

This relationship is reflected in the economic order quantity model, which balances ordering costs against annual holding costs. Holding cost is a denominator in the model's optimal-order-quantity calculation: as annual carrying cost per unit declines, the cost-minimizing order quantity rises. Since average cycle inventory is generally one-half of the order quantity, larger orders normally produce a larger average amount held in stock. The conclusion follows from the fundamental inventory trade-off between the cost of acquiring or ordering inventory and the cost of possessing it. The U.S. Small Business Administration discusses inventory carrying costs and their components in its inventory management guidance. A useful overview of the economic order quantity framework is available from Investopedia.

QUESTION NO: 68

In a decision analysis situation, which one of the following costs is generally not relevant to the decision?

A. Incremental cost.
Incremental cost

B. Avoidable cost.
Avoidable cost

C. Historical cost.

D. Opportunity cost.

Opportunity cost

ANSWER: C

Explanation:

Historical cost is generally not relevant because it is a sunk cost: it reflects an amount incurred in the past that cannot be changed by choosing among current alternatives. Relevant-cost analysis focuses on future amounts that differ depending on the decision made. Because the historical amount has already been committed, it will remain the same whether management selects one alternative or another and therefore cannot affect the economic consequences of the choice. This principle helps decision makers avoid allowing prior expenditures to influence whether they continue, replace, outsource, discontinue, or otherwise alter an activity. The appropriate analysis instead isolates the prospective cash-flow effects and other future economic benefits or sacrifices attributable to each available course of action. The AICPA's management-accounting content describes decision making as evaluating relevant costs and benefits for alternatives, while accounting guidance distinguishes past-cost information from costs that will be affected by a current decision. See the AICPA & CIMA CGMA Competency Framework and the OpenStax discussion of differential analysis.

QUESTION NO: 69

Park and Graham entered into a written partnership agreement to operate a retail store. Their agreement was silent as to the duration of the partnership. Park wishes to dissociate from the partnership. Which of the following statements is correct?

A. Park may dissociate from the partnership at any time.

B. Unless Graham consents to the dissociation, Park must apply to a court and obtain a decree ordering the dissociation.

C. Park may not dissociate from the partnership unless Graham consents.

D. Park may dissociate from the partnership only after notice of the proposed dissolution is given to all partnership creditors.

ANSWER: A

Explanation:

Park may dissociate from the partnership at any time. Because the written agreement does not specify a definite term or a particular undertaking that must be completed, Park and Graham have a partnership at will. Under the Revised Uniform Partnership Act, a partner has the power to dissociate at any time by giving notice of the partner's express will to withdraw. In an at-will partnership, this dissociation is not wrongful merely because it occurs before a stated endpoint; no consent from the other partner and no judicial decree are necessary for Park to exercise that power. Dissociation changes Park's relationship to the business: Park ceases to be a partner, and the partnership is generally dissolved and wound up unless the partners agree to continue the business under applicable law. The partnership agreement can govern many rights and obligations among partners, but silence about duration means the default at-will rule applies. This treatment reflects the voluntary and consensual nature of a general partnership while preserving the statutory rules governing the consequences of withdrawal. See the Uniform Law Commission's Uniform Partnership Act resources and Cornell Law School's overview of partnership law.

QUESTION NO: 70

Which of the following corporate actions is subject to shareholder approval?

A. Election of officers.

B. Removal of officers.

C. Declaration of cash dividends.

D. Removal of directors.

ANSWER: D

Explanation:

Removal of directors is subject to shareholder approval because directors are accountable to the corporation's owners through the shareholder voting process. A corporation's board is generally elected by shareholders, and shareholders ordinarily have the corresponding statutory power to remove directors, subject to applicable state corporate law, the corporation's certificate of incorporation, and any classified-board or cumulative-voting provisions. This governance mechanism lets shareholders act when they no longer support a director's service, typically through a vote at a meeting or by written consent when permitted.

For example, Delaware General Corporation Law § 141(k) provides that shareholders holding a majority of the shares entitled to vote in an election of directors may remove directors, with specific rules for staggered boards and cumulative voting. The Model Business Corporation Act likewise treats removal of directors as a shareholder action. Thus, among the listed corporate actions, removal of directors is the action that requires shareholder approval in the ordinary corporate-governance framework. See Delaware General Corporation Law, § 141 and Cornell Legal Information Institute: Director.

QUESTION NO: 71

Which one of the following management considerations is usually addressed first in strategic planning?

A. Overall goals of the firm.

B. Organizational structure.

C. Recent annual budgets.

D. Being an industry leader.

ANSWER: A

Explanation:

Overall goals of the firm. is correct because strategic planning begins by establishing the organization's fundamental direction: its mission, broad objectives, and intended long-term outcomes. These overall goals provide the criteria for subsequent strategic decisions, including which markets to serve, what competitive position to pursue, how to allocate resources, and which initiatives deserve priority. Management must first identify what the organization is trying to accomplish before it can design plans for accomplishing it.

Clear firm-level goals also align decision-making across the organization. Once leadership has articulated desired results, it can develop strategies, select performance measures, prepare supporting budgets, and establish an organizational structure that enables execution. Strategic planning is therefore future-oriented and goal-driven rather than simply an extension of current operating plans. This sequence is consistent with management-accounting guidance describing planning as the process of setting objectives and determining the actions and resources needed to achieve them. See the COSO guidance resources for the importance of objectives in organizational governance and risk management, and the PwC Strategy& strategic-planning overview for discussion of defining strategic direction before execution decisions.

QUESTION NO: 72

The understanding with a client of an auditor's contractual obligation ordinarily is set forth in the:

A. Management letter.

B. Scope paragraph of the auditor's report.

C. Engagement letter.

D. Introductory paragraph of the auditor's report.

ANSWER: C

Explanation:

An engagement letter ordinarily documents the auditor's contractual understanding with the client. It is prepared at the start of the engagement and establishes the terms on which the auditor will perform services. In particular, it communicates the objective and scope of the audit, the responsibilities of both the auditor and management, the applicable financial reporting framework, the expected form and content of reports, and other relevant engagement conditions. Clearly documenting these matters helps ensure that the auditor and client have a mutual understanding before audit work begins, reducing the risk of misunderstandings about the nature, timing, and extent of services to be provided.

Under AU-C section 210, the auditor must agree on the terms of the audit engagement with management or those charged with governance, as appropriate, and record those agreed terms in an audit engagement letter or another suitable written agreement. This written agreement is the normal vehicle for defining the auditor's professional and contractual obligations, including management's acknowledgement of its responsibilities for preparing the financial statements and maintaining internal control. See the PCAOB's auditing standards and the AICPA AU-C section 210.

QUESTION NO: 73

An auditor decides to use the work of an auditor's specialist in evaluating the fair value of a complex financial instrument. The auditor's responsibility for the audit opinion is:

A. Not reduced by the auditor's use of the specialist.

B. Shared with the specialist.

C. Limited to evaluating the specialist's qualifications.

D. Transferred to management for the fair value estimate.

ANSWER: A

Explanation:

The auditor remains solely responsible for the audit opinion and cannot reduce that responsibility by using the work of an auditor's specialist. The auditor evaluates the specialist's competence, capabilities, and objectivity; obtains an understanding of the specialist's work; and evaluates whether that work provides sufficient appropriate audit evidence. Reference to the auditor's specialist is not made in an unmodified auditor's report because such reference could be misunderstood as a division of responsibility. See AICPA AU-C Section 620, Using the Work of an Auditor's Specialist.

QUESTION NO: 74

A depreciation tax shield is:

A. An after-tax cash outflow.

B. A reduction in income taxes.

C. The expense caused by depreciation.

D. Caused by the fact that depreciation does not affect cash flow.

ANSWER: B

Explanation:

A reduction in income taxes is correct because a depreciation tax shield is the tax savings that result when a business deducts depreciation expense in computing taxable income. Although depreciation is a noncash expense for the period, tax law generally permits the taxpayer to deduct an allowable amount of depreciation from revenues. That deduction reduces taxable income and, assuming the entity has taxable income against which to use the deduction, reduces the income tax it must pay. The annual tax shield is commonly calculated as depreciation expense multiplied by the applicable marginal tax rate. For example, a $10,000 depreciation deduction at a 25% tax rate produces a $2,500 reduction in taxes, which improves the asset’s after-tax operating cash flow by that amount. In capital-budgeting analysis, this tax benefit is important because it is a real cash-tax savings even though depreciation itself does not require a current-period cash payment. The Internal Revenue Service explains that depreciation is an annual deduction that allows a taxpayer to recover the cost or other basis of certain property over its useful life; the associated reduction in taxable income is the source of the tax shield. See IRS Publication 946, How To Depreciate Property and IRS Topic No. 704, Depreciation.

QUESTION NO: 75

If the U.S. dollar increases in value relative to the other major currencies, aggregate demand should:

A. Increase as U.S. goods become more attractive overseas.

B. Decrease as U.S. goods become less attractive overseas.

C. Depends on supply of foreign goods.

D. Not necessarily change.

ANSWER: B

Explanation:

“Decrease as U.S. goods become less attractive overseas.” is correct because an increase in the dollar’s value is an appreciation of the U.S. currency. With an appreciated dollar, foreign purchasers must exchange more of their own currency to buy the same U.S.-produced goods and services. U.S. exports therefore tend to become relatively more expensive to foreign buyers, reducing the quantity of exports demanded. At the same time, foreign goods become relatively cheaper for U.S. purchasers, which tends to increase imports. In the aggregate-demand identity, aggregate demand equals consumption plus investment plus government purchases plus net exports. Net exports are exports less imports, so lower exports and higher imports reduce net exports. Holding consumption, investment, government spending, and other relevant conditions constant, this reduction in net exports shifts aggregate demand downward. The Federal Reserve explains that exchange-rate changes affect international trade by altering the relative prices of domestic and foreign goods, while the IMF describes currency appreciation as making a country's exports more expensive and imports cheaper. See the [Federal Reserve's monetary policy resources] and the [IMF explanation of exchange rates].

QUESTION NO: 76

The monitoring component of internal control excludes:

A. Assessing information derived from external parties.

B. Assessing the quality of internal control performance over time.

C. Improving controls that are not operating effectively.

D. Eliminating controls that are not operating effectively.

ANSWER: D

Explanation:

Eliminating controls that are not operating effectively. is excluded from the monitoring component as presented in this question. Monitoring involves ongoing or separate evaluations of whether internal control components and principles are present and functioning, followed by communication of identified deficiencies to the parties responsible for corrective action. Its purpose is to determine whether controls continue to operate as designed and whether changes are needed to maintain effective internal control over time.

When monitoring identifies a deficient control, the appropriate response is to investigate the deficiency and implement a suitable corrective action, such as redesigning the control, strengthening its operation, assigning responsibility, or replacing it with an effective control. Simply eliminating an ineffective control without establishing an adequate replacement would remove a safeguard and could increase the risk that material misstatements, fraud, or operational errors will not be prevented or detected. Therefore, the act of eliminating ineffective controls is not itself a monitoring activity or an appropriate monitoring response unless the underlying risk is otherwise addressed through a redesigned control structure.

The COSO Internal Control—Integrated Framework describes monitoring as ongoing and separate evaluations used to ascertain whether internal control is functioning effectively. See [COSO Internal Control guidance] and the [PCAOB standard on auditing internal control].

QUESTION NO: 77

Which one of the following is most likely to accompany a reduction in aggregate demand?

A. An increase in the price level.

B. A decrease in employment.

C. An increase in real GDP.

D. A decrease in the unemployment rate.

ANSWER: B

Explanation:

A decrease in employment is most likely to accompany a reduction in aggregate demand. Aggregate demand represents total planned spending on domestically produced final goods and services at different overall price levels. When aggregate demand declines, businesses generally experience weaker sales demand. In the short run, firms respond by reducing production, which lowers real output and reduces the need for labor. As a result, employment falls and unemployment rises. The aggregate demand–aggregate supply model therefore predicts that a leftward shift in the aggregate demand curve is associated with lower real GDP and, assuming an upward-sloping short-run aggregate supply curve, a lower overall price level. This relationship is central to analyzing recessions and cyclical downturns: reduced household consumption, business investment, government purchases, or net exports can decrease aggregate demand and lead firms to cut output and payrolls. The Federal Reserve's overview of economic activity discusses how changes in spending and production affect employment and output: Federal Reserve—Monetary Policy: Goals and Operation. The Bureau of Economic Analysis provides the national-income accounting framework for real GDP, the measure of inflation-adjusted output affected by aggregate-demand changes: BEA—Gross Domestic Product.

QUESTION NO: 78

When managing cash and short-term investments, a corporate treasurer is primarily concerned with:

A. Maximizing rate of return.

B. Minimizing taxes.

C. Investing in common stock due to the dividend exclusion for federal income tax purposes.

D. Liquidity and safety.

ANSWER: D

Explanation:

Liquidity and safety are the primary objectives of a corporate treasurer's cash and short-term investment management. Cash management is designed first to ensure that the company can meet payroll, supplier invoices, debt service, taxes, and other obligations when due. Accordingly, funds held for near-term operating needs must be readily convertible to cash with little delay and without a meaningful risk of loss in principal.

Safety means emphasizing preservation of principal through high-quality, low-risk instruments and prudent diversification. Common treasury-management vehicles can include demand deposits, government securities, Treasury bills, and highly rated short-term money-market instruments, subject to the organization's investment policy. Yield remains relevant, but it is generally a secondary consideration after the timing of cash needs, capital preservation, and access to funds have been established. This priority reflects the fundamental trade-off in short-term financial management: a slightly higher return is not beneficial if the organization cannot access cash when required or faces a material risk that the invested amount will decline in value.

For an overview of cash and liquidity management, see the Corporate Finance Institute cash-management guide and the SEC Investor.gov discussion of cash equivalents.

QUESTION NO: 79

The existence of audit risk is recognized by the statement in the auditor's standard report that the:

A. Auditor is responsible for expressing an opinion on the financial statements, which are the responsibility of management.

B. Financial statements are presented fairly, in all material respects, in conformity with GAAP.

C. Audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

D. Auditor obtains reasonable assurance about whether the financial statements are free of material misstatement.

ANSWER: D

Explanation:

"Auditor obtains reasonable assurance about whether the financial statements are free of material misstatement." correctly recognizes audit risk because an audit provides reasonable assurance, not absolute assurance. Audit risk is the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Since audit procedures involve professional judgment, testing, and evaluation of evidence rather than examination of every transaction or item, some risk necessarily remains even when the audit is properly planned and performed.

The reasonable-assurance statement communicates this inherent limitation directly: the auditor reduces audit risk to an acceptably low level but cannot eliminate it entirely. In the current standard auditor's report, the auditor's responsibility section states that the auditor obtains reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether caused by fraud or error. This language is fundamental to the audit opinion because it defines the level of assurance supporting the auditor's conclusion. See the AICPA's clarified auditing standards resources and PCAOB Auditing Standard 3101 for the reporting framework and reasonable-assurance concept.

QUESTION NO: 80

Under which one of the following conditions is the internal rate of return method less reliable than the net present value technique?

A. When the net present value of the project is equal to zero.

B. When income taxes are considered in the analysis.

C. When both benefits and costs are included, but each is separately discounted to the present.

D. When there are several alternating periods of net cash inflows and net cash outflows.

ANSWER: D

Explanation:

When there are several alternating periods of net cash inflows and net cash outflows, the project has nonconventional cash flows. In that pattern, the cash-flow stream changes sign more than once—for example, an initial outflow, later inflows, and then a subsequent cleanup, overhaul, or abandonment outflow. The internal rate of return is calculated as the discount rate that makes the project's net present value equal to zero. With multiple sign changes, the net-present-value profile can cross zero more than once, meaning that the same project may have multiple mathematically valid internal rates of return (or, in some cases, no meaningful IRR). A single percentage return is therefore ambiguous and can fail to provide a dependable accept-or-reject signal.

Net present value is more reliable in this situation because it discounts each expected cash flow at the entity's required rate of return and aggregates the resulting present values into one dollar amount. That directly measures the project's expected contribution to value at the relevant cost of capital, without requiring selection among multiple possible IRRs. This is why capital-budgeting guidance generally prefers NPV for nonconventional cash-flow patterns. See OpenStax, Net Present Value Method and OpenStax, Internal Rate of Return Method.

QUESTION NO: 81

Audit documentation should be prepared in enough detail so that:

A. An experienced auditor who has worked with the client in the past can understand the procedures performed and the evidence obtained.

B. A reader of the financial statements who has no previous connection with the audit can understand the procedures performed and the evidence obtained.

C. A reader of the financial statements who has a background in financial analysis can understand the procedures performed and the evidence obtained.

D. An experienced auditor who has no previous connection with the audit can understand the procedures performed and the evidence obtained.

ANSWER: D

Explanation:

Audit documentation must be sufficiently detailed to enable an experienced auditor with no prior connection to the engagement to understand the nature, timing, and extent of the audit procedures performed; the results of those procedures and the audit evidence obtained; and significant matters arising during the audit, including the related conclusions. This standard ensures that the audit file provides a clear, self-contained record of how the auditor planned and performed the engagement and how the evidence supports the audit opinion. “Experienced auditor” refers to a professional who has practical auditing experience and a reasonable understanding of audit processes, financial reporting, and the client’s industry—not necessarily someone who previously worked on the client’s audit. The documentation therefore needs enough context to permit an appropriate review, supervision, quality-control inspection, or subsequent evaluation of the work without relying on the original engagement team’s memory. This requirement does not mean that every detail of the audit must be duplicated in the workpapers; rather, the record must clearly demonstrate the work performed and the basis for the auditor’s conclusions. The PCAOB’s documentation standard states this requirement directly in AS 1215, Audit Documentation. The analogous AICPA standard is AU-C section 230, Audit Documentation.

QUESTION NO: 82

On November 1, 20X2, ABC Co. contracted to dispose of an industry segment. Throughout 20X2 the segment had operating losses. These losses were expected to continue until the segment's disposition.

If a loss is projected on final disposition, how much of the operating losses should be included in the loss from discontinued operations reported in ABC's 20X2 income statement?

I. Operating losses for the period January 1 to October 31, 20X2.

II. Operating losses for the period November 1 to December 31, 20X2.

III. Estimated operating losses for the period January 1 to February 28, 20X3.

A. II only.

B. II and III only.

C. I and III only.

D. I and II only.

E. Operating losses for the period January 1 to October 31, 20X2.
II. Operating losses for the period November 1 to December 31, 20X2.
III. Estimated operating losses for the period January 1 to February 28, 20X3.

ANSWER: D

Explanation:

I and II only. is correct because the discontinued-operations result reported for 20X2 includes the component’s actual operating results for the entire 20X2 reporting period. Therefore, the loss includes operating losses incurred from January 1 through October 31, before the November 1 contract to dispose of the segment, as well as actual operating losses incurred from November 1 through December 31. Separate presentation as discontinued operations does not cause actual current-year operating results before the disposal decision to be omitted from the current-year result of the component.

The estimated operating losses expected during January and February 20X3 are not recognized in ABC’s 20X2 income statement merely because management expects them to occur before disposition. Financial reporting generally recognizes losses when incurred or when a present obligation meets the applicable recognition criteria; it does not accrue anticipated future operating losses. Thus, the 20X2 discontinued-operations amount reflects the segment’s realized 20X2 operating performance, while operations occurring in 20X3 are recognized in the 20X3 reporting period. The disposal-related presentation framework is addressed in FASB Accounting Standards Codification Topic 205-20, Discontinued Operations; the SEC’s financial-reporting guidance also discusses separate reporting of discontinued operations in SEC Financial Reporting Manual, Topic 8.

QUESTION NO: 83

An annual shareholders' report includes audited financial statements and contains supplementary information required by GAAP. Is it permissible for the auditor to report on such information?

A. No, because such reporting may lead to the belief that the auditor is responsible for the information.

B. No, because the auditor has no responsibility to read the other information in a document containing audited financial statements.

C. Yes, provided the report provides negative assurance only.

D. Yes, provided the auditor performs sufficient audit procedures to determine whether the information is fairly stated, in all material respects, in relation to the financial statements.

ANSWER: D

Explanation:

Yes, provided the auditor performs sufficient audit procedures to determine whether the information is fairly stated, in all material respects, in relation to the financial statements. Supplementary information required by the applicable financial reporting framework is closely connected to the audited financial statements and may be included in the auditor's reporting responsibilities. The auditor's conclusion is not a separate audit opinion on the supplementary information as a standalone presentation. Instead, it addresses whether that information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

To support that conclusion, the auditor performs appropriate procedures on the supplementary information, including considering whether it agrees with or can be derived from the underlying accounting records and audited financial statements, and whether its presentation complies with the relevant framework. The auditor must obtain sufficient appropriate audit evidence for the relation-to-financial-statements conclusion. When those procedures have been performed and the evidence supports the conclusion, reporting on the supplementary information is permissible and provides users with positive assurance in the stated relational form. The AICPA's guidance on supplementary information is available in AICPA Clarified Statements on Auditing Standards; related public-company guidance is addressed in PCAOB AS 2705, Required Supplementary Information.

QUESTION NO: 84

In a general partnership, the authorization of all partners is required for an individual partner to bind the partnership in a business transaction to:

A. Purchase inventory.

B. Hire employees.

C. Sell goodwill.

D. Sign advertising contracts.

ANSWER: C

Explanation:

Sell goodwill. Goodwill is the value attributable to a business's reputation, established customer relationships, name, and similar advantages that generate future earnings. Selling it is an extraordinary disposition of a significant partnership asset rather than an act in the ordinary course of operating the business. Under the Revised Uniform Partnership Act, each partner is generally an agent of the partnership for acts apparently carried on in the ordinary course of the partnership's business. However, an act outside the ordinary course binds the partnership only when authorized by the other partners. The Act also provides that an amendment to the ordinary-course rule requires consent of all partners, reflecting the fundamental principle that extraordinary partnership decisions require unanimous approval. Thus, an individual partner needs authorization from all partners before binding the partnership to a sale of the business's goodwill. This protects every partner's ownership interest because goodwill can be a substantial component of the value of an ongoing enterprise and its transfer can materially affect the partnership's ability to continue operating. See the agency rule in the Uniform Partnership Act agency provisions and the unanimous-consent rule in Cornell Law School's partnership-law materials.

QUESTION NO: 85

An inventory loss from a permanent market decline of $360,000 occurred in May 1989. ABC Co. appropriately recorded this loss in May 1989 after its March 31, 1989 quarterly report was issued. What amount of inventory loss should be reported in ABC's quarterly income statement for the three months ended June 30, 1989?

A. $0

B. $90,000

C. $180,000

D. $360,000

ANSWER: D

Explanation:

$360,000 is the inventory loss reported for the three months ended June 30, 1989. The loss arose in May, which falls within the second fiscal quarter, April through June. Because the decline is stated to be permanent, the company must recognize the entire write-down when the decline occurs rather than defer it, spread it across quarters, or wait until year-end. The fact that the March 31 quarterly report had already been issued does not alter the accounting period in which the May loss belongs. It simply confirms that the loss was not part of the first-quarter results. Accordingly, ABC records the full $360,000 reduction in inventory and the related loss in its second-quarter interim income statement. Interim reporting applies the same underlying recognition principles used in annual reporting, while presenting results for the discrete interim period. This treatment faithfully reports the economic effect of the permanent reduction in the inventory's recoverable value in the period in which ABC became aware of and recorded that decline. See the SEC's interim-financial-statement requirements in Regulation S-X, Rule 10-01 and the FASB's guidance overview for Accounting Standards Codification.

QUESTION NO: 86

Which of the following is not correct regarding best cost provider strategies?

A. The overall lowest cost in the industry is not a viable option in best cost strategies because the firm could not compete profit-wise with its differentiation strategy component.

B. When generic products are not acceptable to buyers, yet they still remain price sensitive to the value they are receiving for their money, the best cost strategy may work well.

C. The best cost strategy is a combination of the benefits of the cost leadership and differentiation strategies.

D. The best cost strategy strives to have the firm evaluate and change its value chain such that it can achieve the highest cost among its closest competitors with a quality differentiated product in an effort to obtain the highest profits.

ANSWER: D

Explanation:

The statement that a best cost strategy seeks to achieve the highest cost among close competitors while offering a quality-differentiated product is not correct. A best-cost provider strategy is designed to deliver superior customer value by combining appealing product attributes with a cost position that permits a competitive price. The firm seeks to manage and redesign activities in its value chain efficiently, so that its costs are lower than—or at least sufficiently controlled relative to—those of rivals offering comparable differentiated features. This cost discipline lets the company offer buyers more features, quality, service, or performance for the price, or comparable features at a lower price. The objective is not simply to maximize the firm's cost base or charge the highest possible price. Rather, it is to create a favorable value proposition for price-conscious customers who still want differentiated benefits. Properly executed, this approach can support profit through the combination of customer-perceived value, efficient operations, and a price-cost margin that is sustainable against close competitors. Porter's generic-strategy framework recognizes the importance of selecting a coherent competitive position and aligning activities to support it; see Harvard Business School: Generic Strategies. For an overview of value-chain cost drivers and competitive advantage, see Mind Tools: Porter's Value Chain.

QUESTION NO: 87

Which of the following methods of measuring transaction exposure to exchange rate risk uses standard deviation, coefficient of correlation and other formal statistical techniques?

I. Measurement of currency variability.

II. Measurement of currency correlations.

A. I only.

B. II only.

C. Both I and II.

D. Neither I and II.

E. Measurement of currency variability.
II. Measurement of currency correlations.

ANSWER: C

Explanation:

Both I and II. is correct because each method uses formal statistical analysis to assess the uncertainty associated with transaction exposure, which arises when a foreign-currency-denominated receivable or payable will be settled in the future. Measurement of currency variability focuses on the dispersion of historical or expected exchange-rate movements. Standard deviation is a central measure in this approach because it quantifies the extent to which a currency's exchange rate fluctuates around its average value. Greater variability indicates greater uncertainty in the domestic-currency value of a foreign-currency cash flow.

Measurement of currency correlations also relies on statistical techniques, particularly correlation coefficients. This approach is especially useful when an entity has exposures in more than one foreign currency. Correlation analysis measures the degree to which exchange rates tend to move together, allowing management to evaluate whether gains and losses across currency positions may offset each other and to assess the risk of the overall currency portfolio rather than only isolated transactions. These concepts align with standard financial-risk measurement practice: volatility is commonly measured with standard deviation, while co-movement between variables is measured with correlation. See the International Monetary Fund's discussion of volatility and the overview of correlation coefficients.

QUESTION NO: 88

ABC sells to retail stores on credit terms of 2/10, net 30. Daily sales average 150 units at a price of $300 each. Assuming that all sales are on credit and 60 percent of customers take the discount and pay on Day 10 while the rest of the customers pay on Day 30, the amount of Jackson's accounts receivable is:

A. $990,000

B. $900,000

C. $810,000

D. $450,000

ANSWER: C

Explanation:

$810,000 is the correct accounts-receivable balance because the balance equals average daily credit sales multiplied by the average collection period. First, ABC's daily sales are 150 units × $300 per unit, or $45,000 per day. The collection period is a weighted average based on customer payment behavior: 60 percent of sales are collected on Day 10 and 40 percent are collected on Day 30. Thus, the average number of days that a receivable remains outstanding is 18 days: (60% × 10) + (40% × 30). Multiplying $45,000 in daily credit sales by 18 days produces accounts receivable of $810,000. This approach is also consistent with the standard relationship that accounts receivable reflects the amount of credit sales not yet collected at a point in time, often estimated using daily sales and days sales outstanding. The 2 percent discount affects the cash ultimately received from customers who take it, but the question's stated sales price is used to determine the receivable amount under this simplified average-balance calculation. For background on accounts-receivable measurement and presentation, see the FASB Accounting Standards Codification and the SEC's accounting basics guidance.

QUESTION NO: 89

Which of the following types of entities are required to report on business segments?

A. Nonpublic business enterprises.

B. Publicly-traded enterprises.

C. Not-for-profit enterprises.

D. Joint ventures.

ANSWER: B

Explanation:

Publicly-traded enterprises are required to provide segment disclosures because ASC 280, *Segment Reporting*, applies to public entities. Segment reporting is designed to give investors and other users of public-company financial statements a view of the business through management's perspective. It requires information about operating segments, including certain profit-or-loss measures, assets, products and services, geographic areas, and major customers when the applicable disclosure thresholds are met. These disclosures help financial-statement users assess the differing risks, returns, growth prospects, and resource allocations across the components of an enterprise rather than evaluating the entity only as a single consolidated business.

For this purpose, the public-entity scope generally covers entities whose debt or equity securities are publicly traded, as well as entities that are required to file or furnish financial statements with the SEC. The FASB's Codification topic listing identifies ASC 280 as the authoritative U.S. GAAP topic for segment reporting, and the SEC's reporting framework explains the financial-reporting obligations applicable to registrants and public issuers. See the FASB Accounting Standards Codification Topic 280 and the SEC EDGAR filing information.

QUESTION NO: 90

During 1992, ABC Co. increased the estimated quantity of copper recoverable from its mine. ABC uses the units of production depletion method. As a result of the change, which of the following should be reported in ABC's 1992 financial statements?

	Cumulative effect of a change in accounting principle	*Pro forma effects of retroactive application of new depletion base*
A.	Yes	Yes
B.	Yes	No
C.	No	No
D.	No	Yes

A. Cumulative effect of a change in accounting principle: Yes; adjustment of beginning retained earnings: Yes.

B. Cumulative effect of a change in accounting principle: Yes; adjustment of beginning retained earnings: No.

C. Cumulative effect of a change in accounting principle: No; adjustment of beginning retained earnings: No.

D. Cumulative effect of a change in accounting principle: No; adjustment of beginning retained earnings: Yes.

ANSWER: C

Explanation:

“No” for both a cumulative-effect adjustment and an adjustment to beginning retained earnings is correct. Increasing the estimate of recoverable copper changes the denominator used to calculate depletion under the units-of-production method. The newly estimated total recoverable units are used to determine depletion prospectively: the mine’s remaining depreciable (depletable) cost basis is allocated over the revised estimate of units expected to be recovered in the current and future periods. Amounts reported for prior periods remain based on the information and estimates available when those financial statements were prepared.

Under ASC 250, a change in accounting estimate is accounted for prospectively in the period of change when it affects that period, and in future periods when those periods are affected. It is not treated as a change in accounting principle and therefore does not produce a cumulative-effect adjustment. Because prior-period depletion is not restated, beginning retained earnings is not adjusted. The revised depletion rate will affect 1992 depletion expense to the extent of 1992 production after the estimate is revised, as well as the depletion recognized in subsequent periods. See the FASB’s ASC 250 topic overview and the SEC’s Staff Accounting Bulletin guidance on accounting estimates.

QUESTION NO: 91

Gibson purchased stock with a fair market value of $14,000 from Gibson's adult child for $12,000. The child's cost basis in the stock at the date of sale was $16,000. Gibson sold the same stock to an unrelated party for $18,000. What is Gibson's recognized gain from the sale?

A. $0

B. $2,000

C. $4,000

D. $6,000

ANSWER: B

Explanation:

Gibson's recognized gain is **$2,000**. A sale between a parent and child is a related-party transaction under Internal Revenue Code §267. Accordingly, the adult child's $4,000 realized loss on the initial sale ($12,000 sales price less $16,000 basis) is disallowed at that time. The fact that the stock's fair market value was $14,000 does not change the related-party loss rule.

When Gibson later sells the stock to an unrelated party for $18,000, Gibson has a $6,000 realized gain measured from the $12,000 purchase price. However, §267 allows the previously disallowed related-party loss to offset the transferee's later gain, but only up to the amount of that gain. Therefore, Gibson's $6,000 realized gain is reduced by the $4,000 loss that was disallowed to the child, leaving a recognized gain of $2,000. This mechanism prevents a related party from immediately claiming a loss while preserving the loss's effect when the property is ultimately sold outside the related-party group at a sufficient gain. See 26 U.S.C. §267 and the IRS discussion of related-party transactions in Publication 544.

QUESTION NO: 92

ABC, Inc. is interested in measuring its overall cost of capital and has gathered the following data. Under the terms described below, the company can sell unlimited amounts of all instruments.

• ABC can raise cash by selling $1,000, 8 percent, 20-year bonds with annual interest payments.

In selling the issue, an average premium of $30 per bond would be received, and the firm must pay floatation costs of $30 per bond. The after-tax cost of funds is estimated to be 4.8 percent.

• ABC can sell 8 percent preferred stock at par value, $105 per share. The cost of issuing and selling the preferred stock is expected to be $5 per share.

• ABC' common stock is currently selling for $100 per share. The firm expects to pay cash dividends of $7 per share next year, and the dividends are expected to remain constant. The stock willhave to be underpriced by $3 per share, and floatation costs are expected to amount to $5 per share.

• ABC expects to have available $100,000 of retained earnings in the coming year; once these retained earnings are exhausted, the firm will use new common stock as the form of common stockequity financing.

• ABC' preferred capital structure is:

Long-term debt 30%

Preferred stock 20 Common stock 50

The cost of funds from retained earnings for ABC, Inc. is:

A. 7.0 percent.

B. 7.4 percent.

C. 8.1 percent.

D. 7.8 percent.

ANSWER: A

Explanation:

The cost of funds from retained earnings is **7.0 percent.** Retained earnings are internally generated common equity, but they are not cost-free: shareholders could have received those earnings as dividends and invested them elsewhere. Therefore, the relevant cost is the return required by common shareholders, without any deduction for underwriting discounts or flotation costs. Those costs apply only when ABC issues *new* common shares after retained earnings have been used.

Because the expected dividend is stated to remain constant, the appropriate dividend-capitalization model is the zero-growth form: cost of retained earnings = next year's dividend ÷ current common-stock price. ABC expects to pay a $7 dividend per share next year, and its common stock currently sells for $100 per share. Thus, the required return is $7 ÷ $100 = 0.07, or 7.0 percent. The stated preferred capital structure, bond terms, and preferred-stock issuance terms are relevant to ABC's broader weighted-average cost of capital analysis, but they do not alter the specific cost of retained earnings. See OpenStax's discussion of the dividend valuation model at [Valuation of Common Stock] and its coverage of cost of capital at [Cost of Capital].

QUESTION NO: 93

The following information regarding inventory policy was assembled by the ABC Corporation. The company uses a 50-week year in all calculations.

Sales	10,000 units per year
Order quantity	2,000 units
Safety stock	1,300 units
Lead-time	4 weeks

The reorder point is:

A. 3,300 units.

B. 2,100 units.

C. 1,300 units.

D. 5,200 units.

ANSWER: B

Explanation:

2,100 units. is the correct reorder point because a reorder point must cover expected demand during the supplier lead time while preserving the required safety-stock level. ABC's annual demand of 10,000 units is converted using its stated 50-week year: 10,000 ÷ 50 = 200 units per week. With a four-week lead time, expected demand before replenishment arrives is 800 units (200 × 4). The company also requires 1,300 units of safety stock, which is the inventory buffer maintained to protect operations from uncertainty in demand or delivery timing. Accordingly, the reorder point is calculated as lead-time demand plus safety stock: 800 + 1,300 = 2,100 units. When the inventory position reaches 2,100 units, ABC should place its order so that inventory can satisfy normal expected usage during the four weeks before the new order is received, without reducing the balance below the intended safety-stock reserve. This application follows the standard reorder-point planning concept used in inventory management. See Oracle's discussion of reorder point planning and the APICS/ASCM overview of inventory and supply-chain planning principles.

QUESTION NO: 94

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.

ANSWER: A

Explanation:

An independent trust company that has no direct contact with the employees who have recordkeeping responsibilities has possession of the securities. This is an effective preventive control because it segregates physical custody of the marketable securities from responsibility for recording and maintaining the related accounting records. Separating these incompatible duties reduces the opportunity for an employee to remove, pledge, or otherwise misappropriate securities and conceal the action by altering records. Using an independent custodian also provides a layer of protection outside the entity's operating personnel and supports reliable confirmation of securities held on the entity's behalf. In an internal-control framework, safeguarding assets depends heavily on assigning authorization, custody, and recordkeeping functions to different parties where practicable. For readily transferable assets such as marketable securities, independent custody is particularly important because the assets can be converted to cash quickly. The control therefore directly addresses prevention of loss, rather than merely establishing an accounting trail or detecting a shortage after it occurs. The COSO framework identifies segregation of duties and appropriate control activities as important measures for reducing risks to assets and financial reporting; see COSO Internal Control Guidance. Related auditing guidance on considering controls and assessing risks is available in the PCAOB risk assessment standard.

QUESTION NO: 95

Which best describes the documentation completion date?

A. Forty-five days from the report release date, based on PCAOB standards.

B. Sixty days from the report release date, based on PCAOB standards.

C. Seven years from the report release date, based on auditing standards.

D. Five years from the report release date, based on auditing standards.

ANSWER: A

Explanation:

Forty-five days from the report release date, based on PCAOB standards, is correct. PCAOB Auditing Standard 1215 defines the documentation completion date as the date by which the auditor has assembled a complete and final set of audit documentation in the engagement file. For an audit conducted under PCAOB standards, the auditor must complete this assembly process no more than 45 days after the report release date. The report release date is generally the date on which the auditor grants permission to use its report in connection with the financial statements. This deadline promotes timely completion and preservation of the audit record while information from the engagement remains available and reviewable. After the documentation completion date, any additions or changes to the audit documentation must be properly documented, including the reason for the change, when and by whom it was made, and its effect, if any, on the auditor's conclusions. The requirement is set out in PCAOB AS 1215, paragraphs .15 through .16. See PCAOB AS 1215, Audit Documentation. The SEC's related record-retention rule for accountants is available at 17 CFR § 210.2-06.

QUESTION NO: 96

In which stage of supply chain management will the firm's management turn its attention to consolidation of the various departments that make up operations in order to solve the firm's problems, with a focus on customer service?

A. Cross-functional teams.

B. Integrated enterprise.

C. Extended supply chain.

D. Supply chain communities.

ANSWER: A

Explanation:

Cross-functional teams. is correct because this stage represents the shift from managing operational functions as separate silos to coordinating the internal departments that jointly affect the customer experience. Management brings areas such as purchasing, production, inventory management, distribution, sales, and customer service together to address operating problems collectively. The emphasis is on improving customer service through internal coordination: information can be shared across functions, trade-offs can be evaluated jointly, and teams can focus on fulfilling customer needs rather than optimizing only an individual department's performance.

This is an important early integration step in supply chain maturity. A supply chain is inherently cross-functional because the flow of materials, information, and services spans several business activities. Establishing cross-functional teams enables the firm to manage those interdependencies and create a more customer-oriented operating process. As supply-chain integration matures, coordination may subsequently become broader and include enterprise-wide and external trading-partner relationships, but the described consolidation of the firm's own operating departments is specifically the cross-functional-teams stage. The customer-service focus also aligns with the Supply Chain Council's SCOR framework, which treats customer-facing fulfillment and return processes as core supply-chain activities. See ASCM's SCOR Digital Standard overview and CSCMP's supply chain management definitions.

QUESTION NO: 97

On June 30, 1991, ABC Corp. incurred a $100,000 net loss from disposal of a component of a business. Also, on June 30, 1991, ABC paid $40,000 for property taxes assessed for the calendar year 1991. What amount of the foregoing items should be included in the determination of ABC's net income or loss for the six-month interim period ended June 30, 1991?

A. $140,000

B. $120,000

C. $90,000

D. $70,000

ANSWER: B

Explanation:

$120,000 is included as expense in determining the net loss for the six-month interim period. The $100,000 loss from disposal of the business component is recognized in the interim period when the disposal loss is incurred. It is therefore included in full in the June 30 year-to-date interim results.

Although ABC paid the entire $40,000 annual property-tax assessment on June 30, the payment date does not determine the interim-period expense. Property taxes assessed for a calendar year are costs that benefit the full annual period and should be allocated systematically to the periods benefited. For the six months ended June 30, ABC recognizes one-half of the annual assessment: $20,000 ($40,000 × 6/12). The remaining $20,000 relates to the second half of the year and is deferred for recognition in that period.

Accordingly, the year-to-date interim loss includes the full $100,000 disposal loss plus $20,000 of property-tax expense, totaling $120,000. This treatment applies the interim-reporting principle that costs are recognized in the periods they benefit rather than solely when cash is paid. See the SEC's interim-reporting requirements in Regulation S-X, Rule 10-01 and the FASB's Accounting Standards Codification.

QUESTION NO: 98

Absent a specific provision in its articles of incorporation, a corporation's board of directors has the unilateral power to do all of the following, except:

A. Repeal the bylaws.

B. Declare dividends.

C. Fix compensation of directors.

D. Amend the articles of incorporation.

ANSWER: D

Explanation:

Amend the articles of incorporation is correct because the articles are the corporation's foundational governing document, and their amendment ordinarily requires action by both the board and the shareholders. The board generally begins the process by adopting a resolution setting out the proposed amendment and submitting it to shareholders. However, the board's approval alone does not normally complete the amendment; the required shareholder vote must also be obtained. This division of authority protects shareholders' fundamental governance rights because amendments can alter matters such as the corporation's name, authorized shares, capital structure, or other core provisions.

Corporate statutes may permit limited, specifically defined amendments without shareholder approval, such as certain technical changes or changes associated with stock splits. Those narrow statutory exceptions do not alter the general rule tested here: a board does not have unilateral authority to amend the articles merely because no special provision appears in the articles themselves. For example, Delaware's corporate statute requires the board to adopt a resolution declaring an amendment advisable and then submit it to stockholders for approval in the usual case. See Delaware General Corporation Law, § 242. The Model Business Corporation Act similarly provides for board adoption and shareholder approval of proposed amendments; see Model Business Corporation Act.

QUESTION NO: 99

Under properly designed internal control, the same employee most likely would match vendors' invoices with receiving reports and also:

A. Post the detailed accounts payable records.

B. Recompute the calculations on vendors' invoices.

C. Reconcile the accounts payable ledger.

D. Cancel vendors' invoices after payment.

ANSWER: B

Explanation:

Recompute the calculations on vendors' invoices. is correct because both activities are part of the accounts-payable invoice-review and payment-authorization process. Matching the vendor invoice to the receiving report helps establish that the goods or services billed were actually received, in the appropriate quantities, before payment is approved. Recomputing invoice extensions, quantities, discounts, freight, sales tax, and totals further supports the accuracy of the amount being authorized. These tasks are complementary review procedures and can appropriately be performed by the same accounts-payable employee before the invoice is submitted for payment.

A sound segregation-of-duties structure separates authorization and invoice review from custody of cash, recording in the accounting records, and independent reconciliation. However, it is efficient and appropriate for one employee responsible for reviewing an invoice package to perform both matching and mathematical verification, since each procedure contributes directly to establishing the validity and accuracy of the payable. This reflects the broader internal-control principle that control activities should be designed to address transaction risks while assigning incompatible responsibilities to different individuals. The COSO framework discusses control activities and segregation of duties as key elements of an effective internal-control system: COSO Internal Control guidance. The AICPA also identifies internal control as a core audit topic: AICPA Audit and Assurance resources.

QUESTION NO: 100

Considering the SCOR Model of supply chain operations, which of the following key management processes does managing accounts receivable and collections from customers fall into?

A. Plan.

B. Source.

C. Make.

D. Deliver.

ANSWER: D

Explanation:

Deliver. is correct because the SCOR framework treats delivery as the end-to-end process of fulfilling customer demand, from receiving and managing orders through distribution, invoicing, and receipt of payment. Although accounts receivable and collections are accounting activities, they arise directly from completed customer sales and are integral to closing the order-to-cash cycle. A company has not fully realized the commercial result of a delivered order until it has issued the customer invoice, recorded the receivable, and collected the amount due under the agreed payment terms.

Within SCOR's process view, Deliver coordinates the customer-facing and fulfillment-related activities needed to make products or services available to customers and convert that fulfillment into cash. Managing receivables also provides feedback on customer credit status, payment performance, and cash-flow timing, all of which support effective delivery operations and customer-order management. Accordingly, collections from customers belong with the Deliver management process rather than being classified solely by the internal accounting function performing the work. SCOR is maintained by ASCM as a standardized reference framework for supply-chain process management; see ASCM's SCOR Digital Standard information and its SCOR DS overview.

QUESTION NO: 101

The element of the audit planning process most likely to be agreed upon with the client before implementation of the audit strategy is the determination of the:

A. Evidence to be gathered to provide a sufficient basis for the auditor's opinion.

B. Procedures to be undertaken to discover litigation, claims, and assessments.

C. Pending legal matters to be included in the inquiry of the client's attorney.

D. Timing of inventory observation procedures to be performed.

ANSWER: D

Explanation:

The timing of inventory observation procedures to be performed is the planning element most likely to be agreed upon with the client before the audit strategy is implemented. Auditors ordinarily attend physical inventory counting when inventory is material, and this work requires practical coordination with client personnel. The client must identify the locations to be counted, arrange access and safety requirements, ensure relevant employees are available, and communicate the scheduled count date and time. Agreeing on timing enables the auditor to plan staffing, travel, the selection of test counts, and procedures for inventory movements occurring around the count date. This coordination does not transfer responsibility for the audit approach to management: the auditor independently determines the nature, timing, and extent of audit procedures. Rather, it ensures that the auditor can obtain appropriate audit evidence by observing the client's count procedures and performing audit test counts at a time when the inventory records and operations can be properly evaluated. AU-C 501 specifically addresses audit evidence considerations for inventory and requires attendance at physical inventory counting when inventory is material, unless impracticable. See the AICPA's auditing standards resources and the PCAOB's AS 2510, Auditing Inventories.

QUESTION NO: 102

The continual process of re-evaluating the strategic plans includes all of the following significant questions a firm should be concerned with, except:

A. Has the firm been able to attain or maintain competitive advantage?

B. Is the firm able to be profitable under the current strategy?

C. Does the current strategy continue to be aligned with the established goals of the firm?

D. Has the firm been able to adapt to the preferences of its employees?

ANSWER: D

Explanation:

Has the firm been able to adapt to the preferences of its employees? is the correct exception because employee preferences, while potentially relevant to human-resources management and successful implementation, are not a primary test of whether a strategic plan remains sound. Continual strategic evaluation is directed at determining whether the organization's strategy still produces the intended business results and remains viable in its competitive and operating environment. Management should assess whether strategic objectives are being achieved, whether the organization can sustain an advantage, and whether the strategy continues to support its mission, goals, and financial performance.

Employee input and engagement can help management execute a chosen strategy and identify operational concerns. However, adapting the firm's strategy to employee preferences is not, by itself, a significant strategic-control criterion. A firm may need to make difficult operational, staffing, market, or investment choices that do not match every employee preference but are necessary to meet the organization's long-term objectives. Strategic planning therefore centers on organizational direction, performance, alignment, and competitive conditions rather than treating employee preference as a governing measure of strategic success. See OpenStax: Strategic Control and U.S. Small Business Administration: Strategic Planning.

QUESTION NO: 103

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.

ANSWER: C

Explanation:

The financial statements are not in conformity with the FASB Statements regarding the capitalization of leases is the circumstance most likely to lead to an adverse opinion. Financial statements must conform to the applicable financial reporting framework, which for a U.S. GAAP audit includes FASB’s lease-accounting requirements. Lease capitalization affects both the statement of financial position and performance measures because it requires recognition and measurement of lease-related assets and liabilities rather than treating qualifying arrangements solely as period expense. A departure from those requirements can therefore misstate multiple financial-statement elements and related disclosures.

An auditor expresses an adverse opinion when the auditor has obtained sufficient appropriate audit evidence and concludes that misstatements are both material and pervasive to the financial statements. Nonconformity with required lease-accounting guidance can be pervasive when it has broad effects on reported assets, liabilities, expenses, equity, and disclosures. The phrase “most likely” reflects that a sufficiently material and pervasive GAAP departure is the classic basis for an adverse opinion. The governing auditing guidance is available in PCAOB AS 3105, Departures from Unqualified Opinions, and FASB’s lease-accounting topic is summarized at FASB ASC Topic 842, Leases.

QUESTION NO: 104

This question will represent a statement, question, excerpt, or comment taken from various parts of an auditor's documentation file. Letter choices A-P represent a list of the likely sources of the statement, question, excerpt, or comment. Select, as the best answer for each item, the most likely source. Select only one source for each item. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

A. Practitioner's report on management's assertion about an entity's compliance with specified requirements.

B. Auditor's communications on significant deficiencies in internal control.

C. Audit inquiry letter to legal counsel.

D. Lawyer's response to audit inquiry letter.

E. Communication from those charged with governance to the auditor.

F. Auditor's communication to those charged with governance (other than with respect to significant deficiencies in internal control).

G. Report on the application of accounting principles.

H. Auditor's engagement letter.

I. Letter for underwriters.

J. Accounts receivable confirmation request.

K. Request for bank cutoff statement.

L. Explanatory paragraph of an auditor's report on financial statements.

M. Partner's engagement review notes.

N. Management representation letter.

O. Successor auditor's communication with predecessor auditor.

P. Predecessor auditor's communication with successor auditor.

ANSWER: N

Explanation:

Management representation letter is the appropriate source because management is required to provide the auditor with written representations about matters that are material to the financial statements and to the audit. A representation that there have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices is a management assertion about the completeness of information made available to the auditor. It helps the auditor obtain documented evidence that management has disclosed regulatory communications that could indicate accounting, reporting, compliance, or internal-control matters relevant to the financial statements.

Written representations do not substitute for audit procedures, but they are necessary audit evidence and confirm management's responsibilities and its responses to the auditor's inquiries. The auditor ordinarily requests these representations near the audit-report date, and the letter is signed by members of management with appropriate responsibility for, and knowledge of, the matters represented. The wording in this statement is specifically characteristic of the illustrative representations addressing regulatory communications in auditing guidance. See the AICPA's Audit and Attest Standards resources and the PCAOB's written representations standard.

QUESTION NO: 105

When purchasing temporary investments, which one of the following best describes the risk associated with the ability to sell the investment in a short period of time without significant price concessions?

A. Interest rate risk.

B. Purchasing power risk.

C. Financial risk.

D. Liquidity risk.

ANSWER: D

Explanation:

Liquidity risk is the risk that an investor will be unable to sell an investment quickly at, or close to, its current fair value. A temporary investment may be readily marketable under normal conditions, but its liquidity depends on the depth of the market, the number of willing buyers, trading volume, and the time available to complete a sale. If the holder needs cash promptly and must accept a material discount from the investment's quoted or expected value to attract a buyer, the investment has liquidity risk. Thus, the phrase "sell the investment in a short period of time without significant price concessions" directly describes liquidity: the capacity to convert an asset to cash promptly without a substantial loss in value. This consideration is especially important for entities investing surplus cash in short-term instruments because those funds may be needed to meet operating, debt-service, or other near-term obligations. The Financial Accounting Standards Board's fair-value framework recognizes that market conditions and transaction characteristics can affect an asset's exit price, including circumstances in which an orderly sale is not readily available. The SEC also explains that liquidity is a key consideration for money market fund investments and a fund's ability to satisfy redemption requests. See FASB Accounting Standards Codification and SEC Investor Bulletin on Money Market Funds.

QUESTION NO: 106

Which of the following types of audit evidence generally is the most reliable?

A. Inquiries made of management.

B. Confirmation of account information.

C. Analytical procedures.

D. Review of prior-year audit procedures.

ANSWER: B

Explanation:

Confirmation of account information is generally the most reliable evidence among the listed procedures because it is obtained directly by the auditor from an independent external party. A confirmation request is designed, sent, and controlled by the auditor, and the response is returned directly to the auditor. This process reduces the risk that management can alter, omit, or selectively provide the information being evaluated. For example, a bank may confirm a cash balance, a customer may confirm an accounts receivable balance, or a lender may confirm debt terms. The evidence therefore comes from a source outside the entity and addresses a specific financial-statement assertion with relatively direct, documentary support. Audit evidence is evaluated based on both relevance and reliability, and reliability is ordinarily enhanced when evidence is obtained from knowledgeable independent sources outside the entity and received directly by the auditor. The auditor must still assess the respondent's competence, objectivity, and the circumstances of the response, but properly controlled confirmations commonly provide highly persuasive audit evidence. The AICPA's confirmation standard describes the auditor's responsibility to maintain control over external confirmation requests and responses: AU-C Section 505, External Confirmations. The general principles for assessing the sufficiency and appropriateness of audit evidence are addressed in AU-C Section 500, Audit Evidence.

QUESTION NO: 107

An auditor's communication of internal control related matters noted in an audit usually should be addressed to:

A. Management and those charged with governance.

B. The director of internal auditing.

C. The chief financial officer.

D. The chief accounting officer.

ANSWER: A

Explanation:

Management and those charged with governance is correct because both groups have distinct but complementary responsibilities for the entity's internal control. Management is responsible for establishing, maintaining, and evaluating internal control, as well as taking corrective action when deficiencies are identified. Those charged with governance, such as the board of directors or audit committee, oversee the financial-reporting process and management's performance of its control responsibilities.

Under generally accepted auditing standards, the auditor must communicate significant deficiencies and material weaknesses in internal control identified during the audit to those charged with governance, in writing and on a timely basis. Communicating the matters to management as well supports its responsibility to understand the deficiency, assess its implications, and implement remediation. Addressing the communication to both management and those charged with governance ensures that the information reaches the parties responsible for operational correction and independent oversight. This approach promotes effective governance and helps ensure that control issues receive appropriate attention at the proper organizational level.

See AICPA AU-C section 265, Communicating Internal Control Related Matters Identified in an Audit, and the PCAOB's related communication requirements in AS 1305.

QUESTION NO: 108

An auditor most likely would extend substantive tests of payroll when:

A. Payroll is extensively audited by the state government.

B. Payroll expense is substantially higher than in the prior year.

C. Overpayments are discovered in performing tests of details.

D. Employees complain to management about too much overtime.

ANSWER: C

Explanation:

Overpayments are discovered in performing tests of details is correct because identified payroll overpayments are direct evidence that payroll transactions may contain misstatements. The discovery raises the auditor's assessment of the risk that similar errors could exist elsewhere in the payroll population, including errors involving employee authorization, pay rates, hours worked, payroll calculations, or the processing of payroll disbursements. The auditor should evaluate the nature and cause of the misstatement and consider its effect on the planned audit approach. If the error indicates that the original planned procedures may not provide sufficient appropriate audit evidence, the auditor responds by modifying the nature, timing, or extent of further audit procedures. In this context, extending substantive testing means increasing the sample size, testing additional payroll periods or employee files, or performing more detailed recalculations and vouching procedures. This response helps the auditor obtain sufficient appropriate evidence to determine whether the payroll balance and related expenses are free of material misstatement. Auditing standards require the auditor to design and perform further audit procedures that respond to assessed risks and to evaluate misstatements identified during the audit. See PCAOB AS 2301, The Auditor's Responses to the Risks of Material Misstatement and AICPA AU-C Section 330.

QUESTION NO: 109

During 1993 Kay received interest income as follows:

On U.S. Treasury certificates $4,000

On refund of 1991 federal income tax 500

The total amount of interest subject to tax in Kay's 1993 tax return is:

A. $4,500

B. $4,000

C. $500

D. $0

ANSWER: A

Explanation:

$4,500 is the amount includible in Kay's 1993 federal taxable income. Interest paid on U.S. Treasury certificates is interest from obligations of the U.S. government. Although such interest is commonly exempt from state and local income tax, it is generally subject to federal income tax and therefore the entire $4,000 is included on the federal return. The $500 received as interest on the refund of Kay's 1991 federal income tax is also taxable interest income in the year it is received. The underlying federal income-tax refund is not itself income, because it generally represents the return of an amount previously paid; however, interest paid by the government for the use of the taxpayer's money is a separate payment and must be included in gross income. Thus, Kay combines the $4,000 of Treasury-certificate interest with the $500 of federal-refund interest, resulting in taxable interest income of $4,500 for 1993. IRS guidance identifies interest on U.S. obligations as federally taxable and identifies interest received on an income-tax refund as taxable interest. See IRS Topic No. 403, Interest Received and IRS Publication 525, Taxable and Nontaxable Income.

QUESTION NO: 110

The benefits of a just-in-time system for raw materials usually include:

A. Elimination of nonvalue adding operations.

B. Increase in the number of suppliers, thereby ensuring competitive bidding.

C. Maximization of the standard delivery quantity, thereby lessening the paperwork for each delivery.

D. Decrease in the number of deliveries required to maintain production.

ANSWER: A

Explanation:

Elimination of nonvalue adding operations is correct because a just-in-time (JIT) raw-materials system seeks to have materials arrive at the point of use only when they are needed for production. This reduces or eliminates activities that do not add value from the customer's perspective, particularly receiving, moving, handling, and storing excess inventory. By minimizing raw-material inventory, a company can reduce storage space, carrying costs, insurance, potential obsolescence, damage, and the operational effort associated with maintaining inventory records and locations. JIT also supports a smoother production flow by linking deliveries closely to actual production requirements rather than accumulating materials well in advance of use. The system therefore emphasizes efficient processes and removal of waste, which is a central principle of lean operations. Effective JIT implementation depends on reliable suppliers, dependable transportation, accurate production scheduling, and consistent material quality so that materials can be delivered in smaller, timely quantities without disrupting production. The U.S. Small Business Administration describes just-in-time inventory as receiving goods only as needed in the production process, reducing inventory-holding costs. See the U.S. Small Business Administration's inventory-management guidance and the overview of JIT inventory concepts from Investopedia.

QUESTION NO: 111

In the pharmaceutical industry where a diabetic must have insulin no matter what the cost and where there is no substitute, the diabetic's demand curve is best described as:

A. Perfectly elastic.

B. Perfectly inelastic.

C. Elastic.

D. Indifferent.

ANSWER: B

Explanation:

Perfectly inelastic is correct because the question assumes that the diabetic must obtain insulin regardless of its price and has no substitute available. Under those assumptions, a change in price produces no change in the quantity demanded: the individual continues to demand the required amount of insulin even as price rises or falls. The price elasticity of demand is therefore zero, which defines perfectly inelastic demand. Graphically, this relationship is represented by a vertical demand curve at the fixed quantity demanded. This is an extreme economic model that highlights how the availability of substitutes and the necessity of a good affect responsiveness to price. In practice, demand for essential medicines may not be perfectly inelastic in every circumstance because dosage, access, insurance coverage, and financial resources can affect purchases. Nevertheless, the stated facts expressly establish the textbook case: insulin is necessary, there is no alternative, and quantity demanded does not vary with price. The Federal Reserve Bank of St. Louis explains that demand elasticity measures how responsive quantity demanded is to a price change: Federal Reserve Bank of St. Louis—Elasticity of Demand. For a definition and graphical treatment of perfectly inelastic demand, see OpenStax Principles of Economics.

QUESTION NO: 112

ABC Co. is reviewing the following data relating to an energy saving investment proposal:

Cost	$50,000
Residual value at the end of 5 years	10,000
Present value of an annuity of 1 at 12% for 5 years	3.60
Present value of 1 due in 5 years at 12%	0.57

What would be the annual savings needed to make the investment realize a 12% yield?

A. $8,189

B. $11,111

C. $12,306

D. $13,889

ANSWER: C

Explanation:

The annual savings needed is **$12,306**. To earn a 12% yield, the present value of the investment's future cash benefits must equal its initial net investment. The relevant initial cash outflow is $50,000. Because the project also has a $10,000 residual value at the end of year five, that future amount offsets part of the investment, but it must first be discounted to its present value at 12%. Using the applicable present-value factor for a single sum due in five years (approximately 0.57), the residual value has a present value of about $5,700. Thus, the annual energy savings must provide a present value of approximately $44,300 ($50,000 less $5,700).

The savings occur annually for five years, so the required annual amount is determined using the present-value-of-an-annuity factor for five periods at 12% (approximately 3.60). Dividing $44,300 by 3.60 produces approximately $12,306 of annual savings. This is an application of discounted-cash-flow analysis: all future benefits, including recurring savings and terminal residual value, are converted to present values using the required return. See the SEC Investor.gov discussion of present value and compounding and the AccountingCoach overview of capital budgeting.

QUESTION NO: 113

In connection with a proposal to obtain a new client, an accountant in public practice is asked to prepare a written report on the application of accounting principles to a specific transaction. The accountant's report should include a statement that:

A. Any difference in the facts, circumstances, or assumptions presented may change the report.

B. The engagement was performed in accordance with Statements on Standards for Consulting Services.

C. The guidance provided is for management use only and may not be communicated to the prior or continuing auditors.

D. Nothing came to the accountant's attention that caused the accountant to believe that the accounting principles violated GAAP.

ANSWER: A

Explanation:

"Any difference in the facts, circumstances, or assumptions presented may change the report." is correct because a report on the application of accounting principles is necessarily based on the particular facts, circumstances, and assumptions supplied to the accountant. The accountant's conclusion as to the appropriate accounting treatment applies only to that described transaction and factual setting. Including this statement clearly communicates the conditional nature and scope of the conclusion: if relevant facts are omitted, altered, or later develop differently, the accounting conclusion may no longer be applicable. This helps prevent readers from treating the report as a broad opinion applicable to other transactions or to an incomplete factual record. It also appropriately identifies management's responsibility for providing the facts and assumptions on which the analysis rests. The applicable attestation reporting guidance requires the practitioner to communicate the relevant limitations of a report on the application of a financial reporting framework, including that changes in facts or circumstances could affect the conclusion. See the AICPA's Audit and Assurance Standards resources and the Guide to Using AICPA Professional Standards.

QUESTION NO: 114

An accountant's standard report on a compilation of a projection should not include a statement that:

A. There will usually be differences between the forecasted and actual results.

B. The hypothetical assumptions used in the projection are reasonable in the circumstances.

C. The accountant has no responsibility to update the report for future events and circumstances.

D. The compilation of a projection is limited in scope.

ANSWER: B

Explanation:

The statement "The hypothetical assumptions used in the projection are reasonable in the circumstances." should not appear in a standard compilation report because a compilation engagement does not provide assurance on prospective financial information or evaluate the support for management's assumptions. A projection is prospective financial information prepared using one or more hypothetical assumptions. In a compilation, the accountant's role is limited to presenting management's prospective information in the appropriate form; it does not include testing, validating, or expressing an opinion or other assurance about whether the assumptions are reasonable, achievable, or supported.

This limitation is essential because the usefulness of projected results depends heavily on assumptions about future events, and those events remain uncertain. The report therefore distinguishes management's responsibility for the assumptions from the accountant's limited compilation service. A statement affirming that hypothetical assumptions are reasonable would imply an evaluation and level of assurance that the accountant has not performed in a compilation engagement. The AICPA's professional standards resources describe the distinct requirements and reporting responsibilities for compilation and prospective-financial-information engagements; see the AICPA Compilation and Review Standards and the AICPA Attestation Standards.

QUESTION NO: 115

Baum, an unmarried optometrist and sole proprietor of Optics, buys and maintains a supply of eyeglasses and frames to sell in the ordinary course of business. In 1999, Optics had $350,000 in gross business receipts and its year-end inventory was not subject to the uniform capitalization rules. Baum's 1999 adjusted gross income was $90,000 and Baum qualified to itemize deductions.

During 1999, Baum recorded the following information: Business expenses:

Optics cost of goods sold	$35,000
Optics rent expense	$28,000
Liability insurance premium on Optics	$ 5,250
Other expenditures:	
Baum's self-employment tax	$29,750
Baum's self-employment health insurance	$ 8,750
Insurance premium on personal residence. In 1999, Baum's home was totally destroyed by fire. The furniture had an adjusted basis of $14,000 and a fair market value of $11,000. During 1999, Baum collected $3,000 in insurance reimbursement and had no casualty gains during the year.	$ 2,625
Qualified 1999 mortgage interest on a loan to acquire a personal residence	$52,500
Annual interest on a $70,000, 5-year home equity loan. The loan was secured by Baum's home, obtained January 2, 1999. The fair market value of the home exceeded the mortgage and the home equity loan by a substantial amount. The proceeds were used to purchase a car for personal use.	$ 3,500
Points prepaid on January 2, 1999 to acquire the home equity loan	$ 1,400
Real estate taxes on personal residence	$ 2,200
Estimated payments of 1999 federal income taxes	$13,500
Local property taxes on the car value, used exclusively for personal use	$ 300

What amount should Baum report as 1999 net earnings from self-employment?

A. $243,250

B. $252,000

C. $273,000

D. $281,750

ANSWER: D

Explanation:

$281,750 is the amount of net profit produced by Baum's sole-proprietorship operations for the year. The computation begins with the $350,000 of gross business receipts and subtracts the allowable costs and expenses attributable to operating Optics, including the inventory-related costs reflected in the facts. Those deductible business amounts total $68,250, leaving $281,750 of business profit. A sole proprietor reports the business's income and deductible operating expenses on Schedule C; this is the amount that flows into the individual return as the net result of the business.

The question asks for the result of the business-income computation, not taxable income after personal deductions or adjusted gross income after above-the-line adjustments. Consequently, the supplied facts concerning itemized deductions, as well as deductions connected with self-employment tax and self-employed health insurance, do not change the $281,750 business-profit amount. The inventory capitalization statement likewise does not alter the stated calculation because the facts specify that the year-end inventory is not subject to the uniform capitalization rules. IRS guidance explains that a sole proprietor generally uses Schedule C to report business income and expenses, and that inventory costs are accounted for in determining business income. See [IRS Publication 334, Tax Guide for Small Business] and [IRS Schedule C information].

QUESTION NO: 116

Heather, Erika, and Shelby are members in ABC LLC. Heather dies. Absent an agreement to the contrary, what is the result?

A. The LLC must dissolve.

B. The LLC ceases to exist.

C. The LLC is dissolved unless the other members consent to continue.

D. The LLC continues as though nothing happened.

ANSWER: C

Explanation:

The LLC is dissolved unless the other members consent to continue. Under the traditional default LLC rules tested in CPA business-law questions, a member's death is an event of dissociation. In a multi-member LLC, that event triggers dissolution unless the remaining members affirmatively agree to continue the business within the applicable statutory period. Thus, Heather's death does not automatically end the entity at the instant of death; rather, Erika and Shelby have the ability to preserve the LLC by consenting to carry on its business. The question specifically states that there is no agreement to the contrary, so no operating-agreement provision changes this default result.

This approach reflects the rule used in many LLC statutes based on earlier uniform-law principles: member dissociation can lead to dissolution, but the remaining members may elect continuation. For example, Illinois's LLC statute provides for dissolution following a member's dissociation unless all remaining members consent to continue the business within 90 days. See 805 ILCS 180/35-1. For general background on LLCs and the importance of the operating agreement in establishing members' rights and business-continuation terms, see the IRS overview of limited liability companies.

QUESTION NO: 117

ABC Inc. grants credit terms of 1/15, net 30 and projects gross sales for next year of $2,000,000. The credit manager estimates that 40 percent of their customers pay on the discount date, 40 percent on the net due date, and 20 percent pay 15 days after the net due date. Assuming uniform sales and a 360-day year, what is the projected day's sales outstanding (rounded to the nearest whole day)?

A. 20 days.

B. 24 days.

C. 27 days.

D. 30 days.

ANSWER: C

Explanation:

27 days is correct because projected days' sales outstanding represents the weighted-average number of days required to collect credit sales. The stated payment pattern supplies the collection timing and the percentage of customers paying at each point. Customers taking the cash discount pay on day 15, so their contribution is 40% × 15 days, or 6 days. Customers paying on the net due date pay on day 30, so their contribution is 40% × 30 days, or 12 days. The remaining customers pay 15 days after the net due date; because the net due date is day 30, they pay on day 45. Their contribution is 20% × 45 days, or 9 days. Adding the weighted collection periods gives 6 + 12 + 9 = 27 days. The projected gross-sales amount and 360-day-year assumption are consistent with a broader accounts-receivable or DSO calculation, but they are not needed once the customer payment distribution is provided directly. DSO is commonly used to assess the average time receivables remain outstanding and therefore the effectiveness of credit collection. See Investopedia's definition of DSO and the Corporate Finance Institute overview of DSO.

QUESTION NO: 118

The net present value method of capital budgeting assumes that cash flows are reinvested at:

A. The risk-free rate.

B. The cost of debt.

C. The rate of return of the project.

D. The discount rate used in the analysis.

ANSWER: D

Explanation:

The discount rate used in the analysis is correct because net present value measures the value created by a project after converting its expected future cash flows into present-dollar amounts using the firm's required rate of return for cash flows of comparable risk. Conceptually, the NPV framework treats interim cash flows as being available for reinvestment at that same required return, which is the discount rate incorporated into the calculation. This produces a valuation that is internally consistent: the rate used to bring future benefits back to today also represents the opportunity-cost-based return applicable to cash generated before the project's end.

In capital-budgeting practice, the discount rate commonly reflects the organization's weighted-average cost of capital when the project has risk similar to the firm's existing operations; it may instead be a project-specific required return when risk differs. Under either approach, it is the selected discount rate—not a project's internal rate of return—that supplies the reinvestment assumption associated with NPV. NPV is therefore especially useful for deciding whether an investment is expected to add value, because it compares discounted inflows with the initial and subsequent investment outflows using the applicable required return. See OpenStax: Net Present Value and Internal Rate of Return and CFA Institute: Capital Budgeting.

QUESTION NO: 119

Which of the following matters generally is included in an auditor's engagement letter?

A. Management's responsibility for the entity's compliance with laws and regulations.

B. The factors to be considered in setting preliminary judgments about materiality.

C. Management's vicarious liability for illegal acts committed by its employees.

D. The auditor's responsibility to search for significant internal control deficiencies.

ANSWER: A

Explanation:

Management's responsibility for the entity's compliance with laws and regulations is generally included in an audit engagement letter. Before accepting or continuing an audit engagement, the auditor must establish that management acknowledges and understands its responsibilities. Those responsibilities include maintaining appropriate internal control, preparing financial statements in accordance with the applicable financial reporting framework, and providing the auditor with needed information and access. They also include identifying laws and regulations applicable to the entity's activities and taking responsibility for the entity's compliance with them.

Documenting this understanding in the engagement letter helps establish the terms of the audit and reduces the risk that management and the auditor will have differing expectations about their respective roles. The engagement letter is therefore an important element of audit planning and acceptance; it makes clear that the audit does not transfer management's fundamental compliance responsibilities to the auditor. This treatment is consistent with the AICPA's requirements on agreeing to the terms of audit engagements. See AICPA AU-C Section 210, Terms of Engagement and the AICPA Auditing Standards resources.

QUESTION NO: 120

The auditor should obtain sufficient knowledge of the client's information and communication system relevant to financial reporting to understand all of the following, except:

A. Classes of transactions in the entity's operations that are significant to the financial statements, and how those transactions are processed, from initiation to inclusion in the financial statements.

B. The financial reporting process, including development of significant accounting estimates and inclusion of appropriate disclosures.

C. The means the entity uses to communicate roles, responsibilities, and significant matters relating to financial reporting.

D. Control activities related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them.

ANSWER: D

Explanation:

Control activities related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them is the exception. The auditor's required understanding of the entity's information system and communication includes the significant transaction classes, how those transactions are initiated, processed, corrected, transferred to the general ledger, and reported in the financial statements. It also encompasses the financial-reporting process, including significant accounting estimates and disclosures, as well as how the entity communicates financial-reporting roles, responsibilities, and significant matters.

That understanding is obtained to identify and assess risks of material misstatement and to plan further audit procedures. However, the standards do not require the auditor, as part of obtaining this understanding, to identify or understand control activities for every individual account balance, transaction class, disclosure component, and assertion. Instead, the auditor focuses on controls relevant to identified risks and on controls necessary to evaluate the design and implementation of the entity's system of internal control. The scope is therefore risk-based rather than an exhaustive control-by-control review of all possible financial-statement assertions. See the AICPA's clarified auditing standards resources and the PCAOB's AS 2110: Identifying and Assessing Risks of Material Misstatement.

QUESTION NO: 121

An auditor who is testing IT controls in a payroll system would most likely use test data that contain conditions such as:

A. Deductions not authorized by employees.

B. Overtime not approved by supervisors.

C. Time tickets with invalid job numbers.

D. Payroll checks with unauthorized signatures.

ANSWER: C

Explanation:

Time tickets with invalid job numbers. is the appropriate test-data condition because test data are specially prepared transactions that an auditor processes through an application to evaluate whether programmed controls operate as intended. In a payroll system, job numbers are commonly subject to input-validation or edit controls, such as checking that the job number exists in the authorized job master file, is active, and is valid for the employee or labor charge. By submitting a time ticket containing an invalid job number, the auditor can observe whether the system rejects the transaction, flags it for correction, prevents posting to payroll or job-cost records, and produces an appropriate exception record.

This approach directly tests automated application controls rather than merely examining evidence of a manual approval. Effective test data include intentionally invalid or exceptional inputs because those inputs demonstrate whether the system's programmed edits identify and handle errors reliably. The auditor should control the test's execution, document the expected and actual results, and ensure that any test transactions do not improperly affect live payroll records. The GAO's Federal Information System Controls Audit Manual describes using test data to evaluate application controls, and the AICPA provides relevant audit guidance in its Audit and Assurance resources.

QUESTION NO: 122

ABC Corp. failed to accrue warranty costs of $50,000 in its December 31, 1992, financial statements. In addition, a $30,000 change from straight-line to accelerated depreciation was made at the beginning of 1993. Both the $50,000 and the $30,000 are net of related income taxes. What amount should ABC report as prior period adjustments in 1993?

A. $0

B. $30,000

C. $50,000

D. $80,000

ANSWER: C

Explanation:

The amount reported as a prior-period adjustment in 1993 is **$50,000**. ABC's failure to accrue warranty costs in the prior-year financial statements is an error in applying the accounting requirements that existed at the time those statements were prepared. Correcting an error in previously issued financial statements is reflected through an adjustment to the opening balance of retained earnings (net of tax) for the earliest period presented. Because the stated warranty-cost amount is already net of related income taxes, the full $50,000 is the relevant retained-earnings adjustment.

By contrast, changing from straight-line to accelerated depreciation is treated as a change in accounting estimate effected by a change in accounting principle. Such a change is applied prospectively: beginning in 1993, the new method is used based on the asset's then-current carrying amount and remaining useful life. It does not create a correction to the opening retained-earnings balance and therefore does not enter into the prior-period-adjustment amount. This treatment is consistent with the guidance on changes in accounting estimates and error corrections in ASC 250. See the FASB Accounting Standards Codification and the SEC's Financial Reporting Manual.

QUESTION NO: 123

Which of the following is true regarding the presentation of "comprehensive income."

	Must be shown on the face of the income statemet	Related tax effects for components must be disclosed
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Comprehensive income must be reported in a separate statement: Yes; income tax expense or benefit allocated to its components must be disclosed: No.

B. Comprehensive income must be reported in a separate statement: Yes; income tax expense or benefit allocated to its components must be disclosed: Yes.

C. Comprehensive income must be reported in a separate statement: No; income tax expense or benefit allocated to its components must be disclosed: Yes.

D. Comprehensive income must be reported in a separate statement: No; income tax expense or benefit allocated to its components must be disclosed: No.

ANSWER: C

Explanation:

The correct presentation is that a separate statement of comprehensive income is not mandatory, while the income tax expense or benefit allocated to the components of other comprehensive income must be disclosed. U.S. GAAP permits flexibility in where comprehensive income is displayed. An entity may present it in a single continuous statement of income and comprehensive income, in a separate statement that follows the income statement, or within a statement of changes in equity. Accordingly, presentation in a separate statement is an allowed format rather than a required one.

Regardless of the permitted display format selected, users of the financial statements need information about the tax effects associated with the components of other comprehensive income. The related income tax expense or benefit may be shown on the face of the financial statement or disclosed in the notes. This disclosure enables users to understand the after-tax effect of items included in other comprehensive income and how those items reconcile to comprehensive income. The Financial Accounting Standards Board's comprehensive-income guidance is in ASC Topic 220; see the FASB's Accounting Standards Codification. Related SEC financial-statement presentation requirements are available in Regulation S-X.

QUESTION NO: 124

The average collection period for a firm measures the number of days:

A. After a typical credit sale is made until the firm receives the payment.

B. It takes a typical check to "clear" through the banking system.

C. Before a typical account becomes delinquent.

D. In the inventory cycle.

ANSWER: A

Explanation:

The correct answer is **"After a typical credit sale is made until the firm receives the payment."** Average collection period (ACP), also called days sales outstanding, estimates the average time a company takes to collect cash from customers after making credit sales. It is commonly calculated as average accounts receivable divided by net credit sales per day. Thus, the measure connects the accounts-receivable balance to the pace of credit sales and expresses the result in days.

Management, creditors, and analysts use the average collection period to evaluate the effectiveness of receivables collection practices and the amount of cash tied up in customer balances. A shorter collection period generally means credit sales are being converted to cash more quickly, while changes in the measure over time may signal shifts in collection performance, customer payment behavior, or credit policies. The metric is particularly useful when compared with the company's stated credit terms and with prior periods. For further discussion of receivables management and collection-period calculations, see OpenStax, Managing Accounts Receivable and Corporate Finance Institute, Average Collection Period.

QUESTION NO: 125

Property acquisitions that are misclassified as maintenance expense would most likely be detected by an internal accounting control system that provides for:

A. Investigation of variances within a formal budgeting system.

B. Review and approval of the monthly depreciation entry by the plant supervisor.

C. Segregation of duties of employees in the accounts payable department.

D. Examination by the internal auditor of vendor invoices and canceled checks for property acquisitions.

ANSWER: A

Explanation:

Investigation of variances within a formal budgeting system is the control most likely to detect property acquisitions recorded improperly as maintenance expense. A capital acquisition should be recorded as a long-lived asset when it provides probable future economic benefits beyond the current period, while routine maintenance is ordinarily expensed as incurred. Recording an acquisition in maintenance expense distorts both categories: maintenance expense may exceed its budget, and capital-expenditure or property-addition spending may fall below the amount expected in the capital budget. A formal budgetary process compares actual results with approved operating and capital budgets and requires management to investigate significant or unusual differences. That investigation can lead personnel to examine underlying invoices, purchase documentation, and account coding, thereby identifying that an item charged to maintenance should have been capitalized. This control is particularly useful because it evaluates spending patterns at an aggregate level and can reveal classification errors even when the original payment was properly authorized and processed. The COSO Internal Control—Integrated Framework identifies ongoing evaluations and timely communication of deficiencies as important components of effective internal control; budget-to-actual variance review is a common monitoring activity supporting those objectives. Authoritative accounting guidance on property, plant, and equipment is available in the FASB Accounting Standards Codification Topic 360; see also the COSO Internal Control guidance.