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## Topic Break Down

Topic	No. of Questions
Topic 1, Auditing and Attestation	500
Topic 2, Business Environment and Concept	527
Topic 3, Financial Accounting and Reporting	145
Topic 4, Regulation	69
Total	1241

## QUESTION NO: 1

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:

Choice "c" is correct. Test data allows the auditor to determine whether adequate controls exist over data processing. Test data consists of fictitious entries or inputs that are processed through the client's computer system under the control of the auditor. The client's computerized payroll system should have adequate controls to prevent input of invalid employee ID numbers. Choice "a" is incorrect. This control does not involve the client's computer system and therefore cannot be tested using test data.

Choice "b" is incorrect. This control does not involve the client's computer system and therefore cannot be tested using test data. Choice "d" is incorrect. This control does not involve the client's computer system and therefore cannot be tested using test data.

## QUESTION NO: 2

When an auditor increases the planned assessed level of control risk because certain control activities were determined to be ineffective, the auditor would most likely increase the:

- A. Extent of tests of details.
- B. Level of inherent risk.
- C. Extent of tests of controls.
- D. Level of detection risk.

## ANSWER: A

### Explanation:

Choice "a" is correct. When an auditor increases the planned assessed level of control risk because certain control activities were determined to be ineffective, detection risk must be reduced accordingly.

This may be accomplished by increasing the extent of tests of details.

Choice "b" is incorrect. The level of inherent risk is not directly related to the planned level of control risk.

Choice "c" is incorrect. The auditor performs tests of controls to evaluate the operating effectiveness of those controls. Once they have been determined to be ineffective, there would be no reason to perform further tests of those controls.

Choice "d" is incorrect. The level of detection risk that the auditor could accept would decrease if the planned level of control risk increased.

## QUESTION NO: 3

Analytical procedures used in planning an audit should focus on:

- A. Evaluating the adequacy of evidence gathered concerning unusual balances.
- B. Testing individual account balances that depend on accounting estimates.
- C. Enhancing the auditor's understanding of the client's business.
- D. Identifying material weaknesses in internal control.

## ANSWER: C

### Explanation:

Choice "c" is correct. The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain audit evidence for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (a) enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date, and (b) identifying areas that may represent specific risks relevant to the audit.

Choice "a" is incorrect. Analytical procedures to assess the adequacy of evidence would be used in the final review stage.

Choice "b" is incorrect. Testing individual account balances that depend on accounting estimates would be a substantive application of analytical procedures and would not be used in the planning stages of an audit.

Choice "d" is incorrect. Analytical procedures are generally not useful in detecting material weaknesses in the client's internal control.

## QUESTION NO: 4

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:**

Choice "b" is correct. \$110,000 minimum annual before-tax operating cash savings.

Step 1: Determine the after-tax annual cash savings. The question provides the cash outflow and the desired payback period (which is calculated using after-tax cash flows). The \$90,000 annual after-tax cash flows is calculated as follows:

$$\frac{\text{Cost of equipment}}{\text{Expected payback period}} = \frac{360,000}{4 \text{ yrs}} = 90,000 \text{ annual after tax cash saving}$$

Step 2: Determine the amount of the annual depreciation expense. Because the question asks for annual before-tax cash savings, we will need to convert the \$90,000 after-tax cash savings we calculated in Step 1, above, to a before-tax amount. The depreciation tax shield plays a role in the after-tax cash flows, so the annual depreciation of \$60,000 must be calculated, as follows:

$$\frac{\text{Cost of equipment}}{\text{Estimated useful life}} = \frac{360,000}{6 \text{ yrs}} = 60,000 \text{ annual depreciation expense}$$

Step 3: Use algebra to determine the before-tax cash savings. Before-tax cash savings is equal to the after-tax cash savings plus the taxes paid. So:

Let B = annual before-tax operating cash savings

$$\$90,000 \text{ after tax cash savings} + [(B - \$60,000 \text{ depreciation expense}) (.40 \text{ tax rate})] = B$$

$$\$90,000 + [(B - \$60,000) (.40)] = B$$

$$\$90,000 + [.40B - \$24,000] = B$$

$$\$90,000 - \$24,000 = .60B$$

$$\$66,000 = .60B$$

$$\$110,000 = B = \text{annual before-tax operating cash savings}$$

Proof:

Annual before-tax cash savings	\$110,000
<u>Less depreciation expense</u>	<u>(60,000)</u>
Taxable income	50,000
<u>× tax rate</u>	<u>× .40</u>
Taxes paid	<u>\$ 20,000</u>

Therefore:

Annual before tax cash saving	\$110,000
<u>Less: Taxes paid</u>	<u>(20,000)</u>
Annual after tax cash saving	<u>\$ 90,000</u>

## QUESTION NO: 5

Symbol A most likely represents:

- A. Remittance advice file.
- B. Receiving report file.
- C. Accounts receivable master file.
- D. Cash disbursements transaction file.

## ANSWER: C

**Explanation:**

Choice "c" is correct. The accounts receivable master file is the file most likely to be affected by sales and cash receipts transactions, as noted immediately above symbol "A" in the flowchart. Choice "a" is incorrect. Remittance advices are used to update the accounts receivable file, but a separate "remittance advice file" generally is not created. Choice "b" is incorrect. The inventory/purchase/cash disbursements cycle would include a receiving report file, not the revenue cycle. Choice "d" is incorrect. Cash disbursements are not part of the revenue cycle.

## QUESTION NO: 6

According to the FASB conceptual framework, the usefulness of providing information in financial statements is subject to the constraint of:

- A. Consistency.
- B. Cost-benefit.
- C. Reliability.
- D. Representational faithfulness.

**ANSWER: B**

**Explanation:**

Choice "b" is correct. The pervasive constraint on providing information in financial statements is that the cost should be outweighed by the benefit to be derived from providing the information.

SFAC 1 para. 23, SFAC 2 para. 133.

Choice "a" is incorrect. Consistency is an underlying concept for financial statements (and a secondary quality of accounting information), but it is not a constraint on providing information. SFAC 2 para. 120.

Choice "c" is incorrect. Reliability is a primary quality of accounting information and an underlying concept for financial statements, but it is not a constraint on providing information. SFAC 2 para.

58.

Choice "d" is incorrect. Representational faithfulness is an underlying concept for financial statements (as an element of reliability), but it is not a constraint on providing information.

**QUESTION NO: 7**

Karen Parker wants to establish an environmental testing company that would specialize in evaluating the quality of water found in rivers and streams. However, Parker has discovered that she needs either certification or approval from five separate local and state government agencies before she can commence business. Also, the necessary equipment to begin would cost several million dollars.

However, Parker believes that if she is able to obtain capital resources, she can gain market share from the two major competitors. The large capital outlay necessary for the equipment is an example of a(n):

- A. Entry barrier.
- B. Minimum efficiency scale.
- C. Created barrier.
- D. External cost.

**ANSWER: A**

**Explanation:**

Choice "a" is correct. Large capital (money) requirements are the basic example of barriers to entry. A barrier to entry effectively prevents firms from entering the market to compete against existing firms.

Choice "b" is incorrect. Minimum efficient scale is the output level at which long run average costs are minimized. Here, Parker has not even been able to enter the industry.

Choice "c" is incorrect. A created barrier is made by firms already in the industry. Here, Parker's barrier was not created.

Choice "d" is incorrect. An external cost is a cost that the company does not account for, but passes on to the detriment of society.

## QUESTION NO: 8

An audit supervisor reviewed the work performed by the staff to determine if the audit was adequately performed. The supervisor accomplished this by primarily reviewing which of the following?

- A. Checklists.
- B. Working papers.
- C. Analytical procedures.
- D. Financial statements.

## ANSWER: B

### Explanation:

Choice "b" is correct. Audit documentation, or working papers, comprises the principal record of audit procedures performed, evidence obtained, and conclusions reached. Reviewing the working papers allows a supervisor to understand the work performed and the evidence obtained, and to evaluate whether the audit was adequately performed.

Choice "a" is incorrect. Checklists might be used within the audit documentation, but checklists alone would not provide a comprehensive record of the audit procedures performed, the evidence obtained, and conclusions reached.

Choice "c" is incorrect. Analytical procedures might be documented within the working papers, but such procedures alone would not provide a comprehensive record of the audit procedures performed, the evidence obtained, and conclusions reached.

Choice "d" is incorrect. Reviewing the financial statements would provide no information regarding the audit procedures performed, the evidence obtained, or conclusions reached, and therefore would provide no basis on which to review the work performed by the staff.

## QUESTION NO: 9

The ABC Company has just acquired a large account and needs to increase its working capital by \$100,000. The controller of the company has identified a source of funds which is given below:

Pay a factor to buy the company's receivables, which average \$125,000 per month and have an average collection period of 30 days. The factor will advance up to 80 percent of the face value of receivables at 10 percent and charge a fee of 2 percent on all receivables purchased. The controller estimates that the firm would save \$24,000 in collection expenses over the year. Assume the fee and interest are not deductible in advance.

Assume a 360-day year in all of your calculations. The cost of factoring is:

- A. 12.0 percent.
- B. 14.8 percent.
- C. 16.0 percent.
- D. 20.0 percent.

**ANSWER: C**

**Explanation:**

Choice "c" is correct.

	AR	x Fee	x Days in yr/ days in period	Subtotals
AR Submitted	\$125,000	2%	360/30	\$30,000
Amount withheld	<u>(25,000)</u>			
Amount subject to interest	100,000	10%/12	360/30	<u>10,000</u>
Cost to company				40,000
Less: Expenses saved due to outsourcing				<u>(24,000)</u>
Net cost				<u>\$16,000</u>

Net cost/average amount invested =  $\$16,000/\$100,000 = 16\%$

**QUESTION NO: 10**

If consumption is \$70b, investment \$50b, government spending \$20b, exports \$7b, and imports \$5b, what is GDP?

- A. \$152b.
- B. \$138b.
- C. \$140b.
- D. \$142b.

**ANSWER: D**

**Explanation:**

Choice "d" is correct. By the expenditure approach to measuring GDP, GDP equals: Consumption + Investment + Government Spending + Exports - Imports. Thus,  $GDP = 70 + 50 + 20 + 7 - 5 = 142b$ .

## QUESTION NO: 11

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

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

## ANSWER: A

### Explanation:

Choice "a" is correct. The control most likely to be used by an entity in safeguarding against the loss of marketable securities is that an independent trust company that has no direct contact with the employees who have recordkeeping responsibilities, has possession of the securities. For good internal control over the safeguarding of any asset, the individual who has the recordkeeping responsibilities over that asset should never have access to it.

Choice "b" is incorrect. Verifying the securities held in the entity's safe would detect that the loss occurred, but it would not prevent the loss.

Choice "c" is incorrect. Tracing purchases and sales of marketable securities would verify that the transactions were properly recorded, but would not safeguard against loss.

Choice "d" is incorrect. Having one person control the securities in a bank safe-deposit box is a weakness in internal control because that one person can steal the securities. A better system requires that at least two employees have joint control over the securities in a bank safe-deposit box.

## QUESTION NO: 12

Which of the following would an auditor most likely use in determining the auditor's preliminary judgment about materiality?

- A. The anticipated sample size of the planned substantive tests.
- B. The entity's annualized interim financial statements.
- C. The results of the internal control questionnaire.
- D. The contents of the management representation letter.

## ANSWER: B

### Explanation:

Choice "b" is correct. The auditor's preliminary judgment about materiality is generally based on either annualized interim financial statements or annual financial statements from a prior period.

Choice "a" is incorrect. The anticipated sample size for substantive tests is irrelevant in making a preliminary judgment about materiality.

Choice "c" is incorrect. The results of the internal control questionnaire would be relevant for making a preliminary assessment of control risk; however, these results are irrelevant for determining a preliminary level of materiality.

Choice "d" is incorrect. The management representation letter is obtained at the end of the audit and would not be available when preliminary assessments of materiality are made during planning.

## QUESTION NO: 13

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:

Choice "c" is correct. Historical cost is generally not relevant in a decision analysis situation. All of the following costs are relevant in a decision analysis situation:

- A. Incremental cost
- B. Avoidable cost
- D. Opportunity cost

## QUESTION NO: 14

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:**

Choice "a" is correct. The cash basis for financial reporting is not a generally accepted accounting basis of accounting (GAAP); therefore, it is an error. Correction of an error from a prior period is reported as prior period adjustment to retained earnings.

Choice "b" is incorrect. Cash basis reporting is not an accounting principle under accrual accounting principles. Thus, the change from cash basis is not reported as a change in accounting principle. In addition, changes in accounting principle are not prior period adjustments; instead, they are treated retrospectively. Choices "c" and "d" are incorrect. Correction of prior period errors has no effect on the current year's income statement.

**QUESTION NO: 15**

There are multiple active markets for a financial asset with different observable market prices:

<u>Market</u>	<u>Quoted Price</u>	<u>Transaction Costs</u>
A	\$76	\$5
B	\$74	\$2

There is no principal market for the financial asset. What is the fair value of the asset?

- A. \$71**  
Fair value does not include transaction costs.  
Choice "b" is incorrect. This is the net price in Market
- B. \$72**  
This net price indicates that Market B is the most advantageous market, but the net price is not the fair value because fair value does not include transaction costs.  
Choice "d" is incorrect. If Market A were the principal market for the asset, then this would be the fair value of the asset. However, because there is no principal market, the price in the most advantageous market (Market B) is the price of the asset.
- C. \$74**
- D. \$76**

**ANSWER: C**

**Explanation:**

Choice "c" is correct. When there is no principal market, the price in the most advantageous market is the fair value measurement. Although transaction costs are not included in the fair value measurement, they are used to determine the most advantageous market, as follows:

Market A: Net Price = Quoted Price - Transaction Costs = \$76 - 5 = \$71

Market B: Net Price = Quoted Price - Transaction Costs = \$74 - 2 = \$72

Because the net price in Market B is higher than the net price in Market A, Market B is the most advantageous market and the quoted price in Market B (\$74) is the fair value of the asset.

Choice "a" is incorrect. This is the net price in Market

A. Fair value does not include transaction costs.

Choice "b" is incorrect. This is the net price in Market

B. This net price indicates that Market B is the most advantageous market, but the net price is not the fair value because fair value does not include transaction costs.

Choice "d" is incorrect. If Market A were the principal market for the asset, then this would be the fair value of the asset. However, because there is no principal market, the price in the most advantageous market (Market B) is the price of the asset.

## QUESTION NO: 16

Which of the following events occurring in the year under audit would most likely indicate that internal controls utilized in previous years may be inadequate in the year under audit?

- A. The entity announced that the internal audit function would be eliminated after the balance sheet date.
- B. The audit committee chairperson unexpectedly resigned during the year under audit.
- C. The chief financial officer waived approvals on all checks to one vendor to expedite payment.
- D. The frequency of accounts payable check runs was changed from biweekly to weekly.

## ANSWER: C

### Explanation:

Choice "c" is correct. Vouchers should be approved before payment occurs. Overriding this control to expedite payment may result in unauthorized payments being made. The auditor would need to consider this change in evaluating current controls and determining the nature, timing, and extent of testing.

Choice "a" is incorrect. If the internal audit function is being eliminated after the balance sheet date, there would be little effect on the current year's audit.

Choice "b" is incorrect. Resignation of the audit committee chairperson would not imply that internal controls are less adequate than in the past, as long as a new, competent person steps up to become chair.

Choice "d" is incorrect. Changing the frequency of the accounts payable check runs from biweekly to weekly would not automatically imply that controls are inadequate. The auditor would need to review the new procedures to determine whether adequate controls were still in place.

## QUESTION NO: 17

Clark bought Series EE U.S. Savings Bonds after 1989. Redemption proceeds will be used for payment of college tuition for Clark's dependent child. One of the conditions that must be met for tax exemption of accumulated interest on these bonds is that the:

- A. Purchaser of the bonds must be the sole owner of the bonds (or joint owner with his or her spouse).
- B. Bonds must be bought by a parent (or both parents) and put in the name of the dependent child.
- C. Bonds must be bought by the owner of the bonds before the owner reaches the age of 24.
- D. Bonds must be transferred to the college for redemption by the college rather than by the owner of the bonds.

**ANSWER: A**

### Explanation:

Choice "a" is correct. One of the conditions that must be met for tax exemption of accumulated interest on the bonds is that the purchaser of the bonds must be the sole owner of the bonds (or joint owner with his or her spouse).

Choice "b" is incorrect. The bonds must be bought and put in the name of the owner or co-owner, not in the name of the dependent child.

Choice "c" is incorrect. The owner must be at least 24 years old before the bonds issue date.

Choice "d" is incorrect. There is no requirement that the bonds must be transferred to the college for redemption by the college rather than by the owner of the bonds.

## QUESTION NO: 18

In which type of business entity is the entire ownership interest most freely transferable?

- A. General partnership.
- B. Limited partnership.
- C. Corporation.
- D. Limited liability company.

**ANSWER: C**

### Explanation:

Choice "c" is correct. Among the business entities listed, entire ownership interests are most freely transferable in a corporation. Unless transferability is restricted by contract (restricted shares or voting trusts or voting agreements), there are no restrictions on the sale of corporate stock (the common stock represents the stockholders' ownership interest). The right to transfer ownership interests freely is one of the advantages of the corporate form of business.

Choice "a" is incorrect. A general partner in a general partnership may assign his or her right to receive profits or surplus. A general partner cannot assign his interest and confer partnership status on the assignee without unanimous consent of all other partners.

Choice "b" is incorrect. Both general partners and limited partners in a limited partnership may assign the right to receive profits and surplus. Neither general nor limited partners can confer general or limited partnership status on the assignee without the unanimous consent of all general and all limited partners.

Choice "d" is incorrect. In most states, limited liability company (LLC) members may not sell and confer ownership interest without the consent of all LLC members.

## QUESTION NO: 19

A project's net present value, ignoring income tax considerations, is normally affected by the:

- A. Proceeds from the sale of the asset to be replaced.
- B. Carrying amount of the asset to be replaced by the project.
- C. Amount of annual depreciation on the asset to be replaced.
- D. Amount of annual depreciation on fixed assets used directly on the project.

## ANSWER: A

### Explanation:

Choice "a" is correct. A project's net present value is a function of current and future cash flows, including proceeds from the sale of the old asset.

Choice "b" is incorrect. A project's net present value is a function of current and future cash flows. The carrying amount of the asset does not affect cash flows. Choice "c" is incorrect. A project's net present value is a function of current and future cash flows. Depreciation is a noncash item and does not affect cash flows.

Choice "d" is incorrect. A project's net present value is a function of current and future cash flows. Depreciation is a noncash item and does not affect cash flows.

## QUESTION NO: 20

According to the FASB conceptual framework, the process of reporting an item in the financial statements of an entity is:

- A. Allocation.
- B. Matching.
- C. Realization.
- D. Recognition.

## ANSWER: D

**Explanation:**

Choice "d" is correct. Recognition is the process of recording an item in the financial statements of an entity. SFAC 5 para. 6.

Choice "a" is incorrect. Allocation is the accounting process of assigning or distributing an amount according to a plan or a formula. SFAC 6 para. 142.

Choice "b" is incorrect. Matching of costs and revenues is simultaneous or combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events. SFAC 6 para. 146.

Choice "c" is incorrect. Realization is the process of converting noncash resources and rights into money. SFAC 6 para. 143.