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CPA

Certified Public Accountant



Sections

1. Auditing and Attestation
2. Business Environment and Concept
3. Financial Accounting and Reporting
4. Regulation

Exam A

QUESTION 1

Several sources of GAAP consulted by an auditor are in conflict as to the application of an accounting principle. Which of the following should the auditor consider the most authoritative?

- A. FASB Technical Bulletins.
- B. AICPA Accounting Interpretations.
- C. FASB Statements of Financial Accounting Concepts.
- D. AICPA Technical Practice Aids.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. In accordance with the GAAP hierarchy, FASB Technical Bulletins are considered the most authoritative of the sources listed in the question.

Choice "b" is incorrect. Of the sources listed, AICPA Accounting Interpretations would be considered the second most authoritative.

Choice "c" is incorrect. FASB Statements of Financial Accounting Concepts are among the least authoritative sources of GAAP available to auditors. Choice

"d" is incorrect. AICPA Technical Practice Aids are among the least authoritative sources of GAAP available to auditors.

QUESTION 2

For an entity's financial statements to be presented fairly in conformity with generally accepted accounting principles, the principles selected should:

- A. Be applied on a basis consistent with those followed in the prior year.
- B. Be approved by the Auditing Standards Board or the appropriate industry subcommittee.
- C. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
- D. Match the principles used by most other entities within the entity's particular industry.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Financial statements are presented fairly in conformity with GAAP when there are no material misstatements included therein. The fact that there may occasionally be immaterial misstatements means that the financial statements are correct "within a range of acceptable limits."

Choice "a" is incorrect. Accounting principles may change from year to year. As long as such changes are properly accounted for, the financial statements are still in conformity with GAAP.

Choice "b" is incorrect. The AICPA and the FASB determine GAAP, not the Auditing Standards Board.

Choice "d" is incorrect. There is no requirement that an entity's financial statements be prepared in accordance with prevalent industry practices in order to be in conformity with GAAP.

QUESTION 3

Which of the following statements is correct concerning an auditor's responsibilities regarding financial statements?

- A. An auditor may not draft an entity's financial statements based on information from management's accounting system.
- B. The adoption of sound accounting policies is an implicit part of an auditor's responsibilities.
- C. An auditor's responsibilities for audited financial statements are confined to the expression of the auditor's opinion.
- D. Making suggestions that are adopted about an entity's internal control environment impairs an auditor's independence.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. An auditor's responsibility is to express an opinion on financial statements based on an audit.

Choice "a" is incorrect. An auditor may draft an entity's financial statements based on information from management's financial system. This would be referred to as a compilation engagement.

Choice "b" is incorrect. The adoption of sound accounting policies is an implicit part of management's responsibilities, not the auditor's responsibilities. Choice "d" is incorrect. An auditor often makes suggestions that are adopted about an entity's internal control environment.

QUESTION 4 Which of the following provides the most authoritative guidance for an auditor?

- A. An AICPA audit and accounting guide that provides specific guidance with respect to the accounting practices in the client's industry.
- B. A Journal of Accountancy article discussing implementation of a new standard.
- C. General guidance provided by a Statement on Auditing Standards.
- D. Specific guidance provided by an interpretation of a Statement on Auditing Standards.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. General guidance provided by a Statement on Auditing Standards is the most authoritative of level of auditing guidance. Auditors are required to comply with SASs, and should be prepared to justify any departures therefrom.

Choices "a" and "d" are incorrect. AICPA audit and accounting guides and SAS interpretations are interpretive publications that provide guidance regarding how SASs should be applied in specific situations. They are not as authoritative as SASs.

Choice "b" is incorrect. Journal of Accountancy articles have no authoritative status but may be helpful to the auditor.

QUESTION 5

Which of the following accurately depicts the auditor's responsibility with respect to Statements on Auditing Standards?

- A. The auditor is required to follow the guidance provided by the Standards, without exception.
- B. The auditor is generally required to follow the guidance provided by Standards with which he or she is familiar, but will not be held responsible for departing from provisions of which he or she was unaware.
- C. The auditor is generally required to follow the guidance provided by the Standards, unless following such guidance would result in an audit that is not cost-effective.
- D. The auditor is generally required to follow the guidance provided by the Standards, and should be able to justify any departures.

Correct Answer: D

Section: Auditing and Attestation Explanation



Explanation/Reference:

Explanation:

Choice "d" is correct. The auditor is generally required to follow the guidance provided by the Standards, and should be able to justify any departures.

Choice "a" is incorrect. On rare occasions, the auditor may depart from the guidance provided by the SASs, but he or she must justify such departures.

Choice "b" is incorrect. Lack of familiarity with a SAS is not a valid reason for departing from its guidance.

The auditor is expected to have sufficient knowledge of the SASs to identify those that are applicable to a given audit engagement.

Choice "c" is incorrect. The cost associated with following the guidance provided by a SAS is not an acceptable reason for departing from its guidance.

QUESTION 6

In the first audit of a new client, an auditor was able to extend auditing procedures to gather sufficient evidence about consistency. Under these circumstances, the auditor should:

- A. Not report on the client's income statement.
- B. Not refer to consistency in the auditor's report.
- C. State that the consistency standard does not apply.
- D. State that the accounting principles have been applied consistently.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods.

Since the auditor has gathered sufficient evidence about consistency, no reference need be made in the report.

Choice "a" is incorrect. If the auditor is able to obtain sufficient evidence about consistency, the auditor may report on the entity's financial statements.

Choice "c" is incorrect. The consistency standard is one of the ten GAAS, and it does apply to this audit.

Choice "d" is incorrect. If the auditor is able to obtain sufficient evidence about consistency, no mention of consistency need be made. Consistency is implied in the standard report.

QUESTION 7

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.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The third general standard of due care is ordinarily interpreted to require critical review of the judgment exercised at every level of supervision, and the judgment exercised by those assisting in the audit. Choice "a" is incorrect. The third general standard of due care does not require a thorough review of the existing safeguards over access to assets and records.

Choice "b" is incorrect. The standard of due care does not specifically require a limited review of the indications of employee fraud and illegal acts. Choice

"c" is incorrect. The standard of due care does not require a review of audit staff training and proficiency.

QUESTION 8 The concept of materiality would be least important to an auditor when considering the:

- A. Adequacy of disclosure of a client's illegal act.
- B. Discovery of weaknesses in a client's internal control.
- C. Effects of a direct financial interest in the client on the CPA's independence.
- D. Decision whether to use positive or negative confirmations of accounts receivable.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

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

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

Choice "b" is incorrect. A material weakness in internal control will affect the nature, timing, and extent of audit procedures, whereas an immaterial weakness in internal control may have little impact on the audit. Choice

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

QUESTION 9 An auditor of a nonpublic company must conduct the audit in accordance with:

- I. ASB standards.
 - II. PCAOB standards.
- A. I.
 - B. Both I and II.
 - C. Either I or II, but not both.
 - D. II.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. An auditor of a nonpublic company must conduct the audit in accordance with ASB standards.

Choice "b" is incorrect. An auditor of a nonpublic company is not required to conduct the audit in accordance with PCAOB standards.

Choice "c" is incorrect. While an auditor is only required to conduct the audit in accordance with ASB standards, the auditor may choose to follow PCAOB standards as well. Choice

"d" is incorrect. An auditor of a nonpublic company is not required to conduct the audit in accordance with PCAOB standards.

QUESTION 10 Because of the risk of material misstatement, an audit of financial statements in accordance with generally accepted auditing standards should be planned and performed with an attitude of:

- A. Objective judgment.
- B. Independent integrity.
- C. Professional skepticism.
- D. Impartial conservatism.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The auditor should plan and perform the audit with an attitude of professional skepticism. This attitude includes a questioning mind and a critical assessment of audit evidence. Choices "a", "b", and "d" are incorrect. Objectivity, independence, integrity, and impartiality are basic ethical characteristics and professional qualities embodied in the general standards.

QUESTION 11 Which of the following is not an example of the application of professional skepticism?

- A. Designing additional auditing procedures to obtain more reliable evidence in support of a particular financial statement assertion.
- B. Obtaining corroboration of management's Explanation: s through consultation with a specialist.
- C. Inquiring of prior year engagement personnel regarding their assessment of management's honesty and integrity.
- D. Using third party confirmations to provide support for management's representations.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The auditor should consider that fraud might occur regardless of any past experience with the entity. An assessment of management's honesty and integrity performed during the previous year would not necessarily be relevant to the current year's audit.

Choice "a" is incorrect. An auditor might apply professional skepticism by performing additional audit procedures designed to improve the reliability of evidence.

Choice "b" is incorrect. Corroborating management's Explanation: s is an example of the application of professional skepticism, since the auditor is obtaining additional support rather than simply accepting the Explanation: as given. Choice "d" is incorrect. Using third party confirmations to provide support for management's representations is an example of the application of professional skepticism, since the auditor is obtaining additional support rather than simply accepting the explanation: as given.

QUESTION 12 Which of the following categories is included in generally accepted auditing standards?

- A. Standards of review.
- B. Standards of planning.
- C. Standards of fieldwork.
- D. Standards of evidence.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Generally accepted auditing standards include three categories: general standards, standards of fieldwork, and standards of reporting. Choices "a", "b", and "d" are incorrect, based on the above explanation.

QUESTION 13

When qualifying an opinion because of an insufficiency of audit evidence, an auditor should refer to the situation in the:

	<u>Scope paragraph</u>	<u>Notes to the financial statements</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. When a qualified opinion is issued due to a lack of sufficient audit evidence, the lack of evidence should be disclosed in an explanatory paragraph before the opinion paragraph. Since insufficient evidence is a scope limitation, the scope paragraph should also be modified to refer to the limitation and to the explanatory paragraph that discusses it.

Choices "a" and "c" are incorrect. Management (and not the auditor) prepares the notes to the financial statements. The auditor therefore would not refer to this (or any other) situation in the notes to the financial statements. Choice "d" is incorrect. The auditor does refer to the situation in the scope paragraph.

QUESTION 14

When an auditor believes there is substantial doubt about the ability of an entity to continue as a going concern, all of the following should be included in the audit documentation, except:

- A. The conditions that gave rise to the substantial doubt.
- B. The auditor's conclusion about whether substantial doubt remains or is alleviated.
- C. Management's conclusion regarding whether substantial doubt remains or is alleviated.
- D. The effect of the auditor's conclusion on the auditor's report.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Whether substantial doubt remains or is alleviated is a judgment call made by the auditor, and there is no requirement to document management's opinion on the matter.

Choices "a", "b", and "d" are incorrect. When an auditor believes there is substantial doubt about the ability of an entity to continue as a going concern, the conditions that gave rise to the substantial doubt, the auditor's conclusion about whether substantial doubt remains or is alleviated, and the effect of the auditor's conclusion on the auditor's report should all be documented.

QUESTION 15

After considering an entity's negative trends and financial difficulties, an auditor has substantial doubt about the entity's ability to continue as a going concern. The auditor's considerations relating to management's plans for dealing with the adverse effects of these conditions most likely would include management's plans to:

- A. Increase current dividend distributions.
- B. Reduce existing lines of credit.
- C. Increase ownership equity.
- D. Purchase assets formerly leased.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The auditor considers any of management's plans that might serve to mitigate the adverse effects of particular conditions and events. Typically, plans to increase ownership equity, to borrow money, to restructure debt, to sell assets, and/or to reduce or delay expenditures might all be considered mitigating factors.

Choices "a", "b", and "d" are incorrect. Increasing dividend distributions, reducing lines of credit, and purchasing assets would not improve a weak cash flow situation.

QUESTION 16

In which of the following situations would an auditor ordinarily choose between expressing a qualified opinion or an adverse opinion?

- A. The auditor did not observe the entity's physical inventory and is unable to become satisfied about its balance by other auditing procedures.
- B. Conditions that cause the auditor to have substantial doubt about the entity's ability to continue as a going concern are inadequately disclosed.
- C. There has been a change in accounting principles that has a material effect on the comparability of the entity's financial statements.
- D. The auditor is unable to apply necessary procedures concerning an investor's share of an investee's earnings recognized on the equity method.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Inadequate disclosure of the substantial doubt about an entity's ability to continue as a going concern is a departure from GAAP, resulting in either a qualified or adverse opinion. Choices "a" and "d" are incorrect. Scope limitations result in either a qualified opinion or in a disclaimer of opinion, but not in an adverse opinion.

Choice "c" is incorrect. A change in accounting principle results in a modified unqualified report, as long as the change was accounted for properly.

QUESTION 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.



Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Indications of possible financial difficulties, such as denial of usual trade credit from suppliers, may cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.

Choice "a" is incorrect. The existence of related parties and the occurrence of related party transactions do not indicate doubt about the entity's ability to continue as a going concern.

Choice "c" is incorrect. Payment of preferred stock dividends in arrears might very well indicate an improvement in the entity's financial situation. It is the lack of payment of preferred, cumulative dividends (a possible indication of financial difficulty) that might cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.

Choice "d" is incorrect. Restrictions on the disposal of assets might limit the options available to management as far as mitigating adverse conditions, but it would not in and of itself cause the auditor to have substantial doubt about an entity's ability to continue as a going concern.

QUESTION 18

In the first audit of a client, an auditor was not able to gather sufficient evidence about the consistent application of accounting principles between the current and prior year, as well as the amounts of assets or liabilities at the beginning of the current year. This was due to the client's record retention policies. If the amounts in question could materially affect current operating results, the auditor would:

- A. Be unable to express an opinion on the current year's results of operations and cash flows.
- B. Express a qualified opinion on the financial statements because of a client-imposed scope limitation.
- C. Withdraw from the engagement and refuse to be associated with the financial statements.
- D. Specifically state that the financial statements are not comparable to the prior year due to an uncertainty.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Since the auditor was unable to gather sufficient evidence on the beginning balances of the balance sheet accounts, the auditor would be unable to express an opinion on the current year's results of operations and cash flows. The auditor could express an opinion on the statement of financial position.

Choice "b" is incorrect. Since the scope limitation could have a pervasive effect on the financial statements (affecting all assets and liabilities), a disclaimer of opinion (and not merely a qualified opinion) is required on the income statement and statement of cash flows. An opinion may be expressed on the year-end statement of financial position.

Choice "c" is incorrect. The auditor does not need to withdraw from the engagement and refuse to be associated with the financial statements. Choice

"d" is incorrect. An uncertainty does not exist. The auditor can express an opinion on one of the financial statements.

QUESTION 19

Pell, CPA, decides to serve as principal auditor in the audit of the financial statements of Tech Consolidated, Inc. Smith, CPA, audits one of Tech's subsidiaries. In which situation(s) should Pell make reference to Smith's audit?

- I. Pell reviews Smith's audit documentation and assumes responsibility for Smith's work, but expresses a qualified opinion on Tech's financial statements.
- II. Pell is unable to review Smith's audit documentation; however, Pell's inquiries indicate that Smith has an excellent reputation for professional competence and integrity.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The principal auditor makes reference in the audit report to the work of the other auditor when the principal auditor is unable to review the other auditor's audit documentation. This is because the principal auditor will be unable to be satisfied concerning the work performed by the other auditor. Even though the other auditor has an excellent reputation, the principal auditor must see the work to be able to assume responsibility for it.

Choice "a" is incorrect. When the principal auditor decides to assume responsibility for the work of the other independent auditor, no reference is made to the work of the other auditor, regardless of the type of audit report expressed.

Choice "c" is incorrect. When the principal auditor decides to assume responsibility for the work of the other independent auditor, no reference is made to the work of the other auditor, regardless of the type of audit report expressed. Choice "d" is incorrect. The principal auditor will make reference in the audit report to the work of the other auditor when the principal auditor is unable to review the other auditor's audit documentation. This is because the principal auditor will be unable to be satisfied concerning the work performed by the other auditor. Even though the other auditor has an excellent reputation, the principal auditor must see the work to be able to assume responsibility for it.

QUESTION 20

Cooper, CPA, believes there is substantial doubt about the ability of Zero Corp. to continue as a going concern for a reasonable period of time. In evaluating Zero's plans for dealing with the adverse effects of future conditions and events, Cooper most likely would consider, as a mitigating factor, Zero's plans to:

- A. Discuss with lenders the terms of all debt and loan agreements.
- B. Strengthen internal controls over cash disbursements.
- C. Purchase production facilities currently being leased from a related party.
- D. Postpone expenditures for research and development projects.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When assessing management's plans for dealing with the adverse effects of future conditions and events, mitigating factors would include:

1. The postponement of expenditures (including R&D),
2. Plans to dispose of assets,
3. Plans to borrow money or restructure debt,
4. Plans to increase ownership equity (sell stock).

Choice "a" is incorrect. Discussions with lenders regarding terms would not be a mitigating factor. Actual agreements regarding restructuring of debt or amendments to covenants would be required.

Choice "b" is incorrect. Strengthening internal controls over cash would not qualify as a management tactic to address going concern issues. Choice "c" is incorrect. Purchasing facilities which are currently being leased would only further decrease cash flow.

QUESTION 21 Which of the following statements is a basic element of the auditor's standard report?

- A. The disclosures provide reasonable assurance that the financial statements are free of material misstatement.
- B. The auditor evaluated the overall internal control.
- C. An audit includes assessing significant estimates made by management.

D. The financial statements are consistent with those of the prior period.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The auditor's standard audit report includes a statement that "An audit includes assessing...significant estimates made by management..."

Choice "a" is incorrect. The standard audit report does not state that disclosures provide reasonable assurance that the financial statements are free of material misstatement. The correct statement is:

"...standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement."

Choice "b" is incorrect. The standard audit report does not state that the auditor evaluated the overall internal control. The correct statement is "An audit includes...evaluating the overall financial statement presentation." Internal control is not mentioned in the standard audit report.

Choice "d" is incorrect. The standard audit report does not state "The financial statements are consistent with those of the prior period." According to the second standard of reporting, consistency is implicitly reported. Only if there is an inconsistency is an explicit statement included.

QUESTION 22 An auditor may not issue a qualified opinion when:

- A. An accounting principle at variance with GAAP is used.
- B. The auditor lacks independence with respect to the audited entity.
- C. A scope limitation prevents the auditor from completing an important audit procedure.
- D. The auditor's report refers to the work of a specialist.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. If the auditor lacks independence with respect to an audit client, the auditor must disclaim an opinion on the financial statements. A qualified opinion is not an option. Choice

"a" is incorrect. A departure from GAAP (which is not sufficiently material to warrant an adverse opinion) may justify a qualification of the auditor's report.

Choice "c" is incorrect. A scope limitation may result in a qualified opinion or a disclaimer of opinion.

Choice "d" is incorrect. The auditor's report may make reference to the use of a specialist only if the specialist's findings result in a change to the auditor's report, such as a qualified opinion.

QUESTION 23

An auditor most likely would express an unqualified opinion and would not add explanatory language to the report if the auditor:

- A. Wishes to emphasize that the entity had significant transactions with related parties.
- B. Concurs with the entity's change in its method of computing depreciation.
- C. Discovers that supplementary information required by FASB has been omitted.
- D. Believes that there is a probable likelihood of a material loss resulting from an uncertainty that is sufficiently supported and disclosed.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. An auditor most likely would express an unqualified opinion and would not add explanatory language to the report if the auditor believes that there is a probable likelihood of a material loss resulting from an uncertainty that is sufficiently supported and disclosed.

Choice "a" is incorrect. Emphasis of a matter, such as the existence of significant transactions with related parties, may result in an additional explanatory paragraph appended to an otherwise unqualified opinion.

Choice "b" is incorrect. A change in accounting principle does result in an additional explanatory paragraph appended to an otherwise unqualified opinion.

Choice "c" is incorrect. Omission of supplemental information required by GAAP does result in an additional explanatory paragraph appended to an otherwise unqualified opinion.

QUESTION 24

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

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

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. An unjustified accounting change may cause the auditor to issue a qualified or adverse opinion. A material weakness must be reported to management and those charged with governance, but would not be disclosed in an explanatory paragraph appended to an otherwise unqualified opinion. Choices "a", "b", and "c" are incorrect, as per the above explanation.

QUESTION 25 Digit Co. uses the FIFO method of costing for its international subsidiary's inventory and LIFO for its domestic inventory. Under these circumstances, the auditor's report on Digit's financial statements should express an:

- A. Unqualified opinion.
- B. Opinion qualified because of a lack of consistency.
- C. Opinion qualified because of a departure from GAAP.
- D. Adverse opinion.



Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. GAAP allows a company to use different methods for costing different inventories as long as the methods are disclosed. Thus, the audit report would be unqualified; there is no departure from GAAP.

Choice "b" is incorrect. The consistency standard refers to changes in application of accounting practices between periods, affecting the comparability of financial statements. There is no indication Digit made any change in methods.

Choice "c" is incorrect. Use of different methods for costing inventory is permissible under GAAP, and would not result in a qualification of the auditor's report. Choice "d" is incorrect. Use of different methods for costing inventory is permissible under GAAP, and would not result in an adverse report.

QUESTION 26 In which of the following circumstances would an auditor not express an unqualified opinion?

- A. There has been a material change between periods in accounting principles.
- B. Quarterly financial data required by the SEC has been omitted.
- C. The auditor wishes to emphasize an unusually important subsequent event.
- D. The auditor is unable to obtain audited financial statements of a consolidated investee.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The inability to obtain audited financial statements of a consolidated investee represents a scope limitation which may result in either a qualified opinion or a disclaimer of opinion.

Choice "a" is incorrect. A material change in accounting principles between periods is disclosed in an explanatory paragraph added to an otherwise unqualified opinion.
 Choice "b" is incorrect. Omission of selected quarterly data required by SEC regulations is disclosed in an explanatory paragraph added to an otherwise unqualified opinion. Choice "c" is incorrect. Emphasis of a matter is disclosed in an explanatory paragraph added to an otherwise unqualified opinion.

QUESTION 27 Management of Edgington Industries plans to disclose an uncertainty as follows:

The Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming damages. Discovery proceedings are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

The auditor is satisfied that sufficient audit evidence supports management's assertions about the nature and disclosure of the uncertainty. What type of opinion should the auditor express under these circumstances?

- A. Unqualified without an explanatory paragraph.
- B. "Subject to" qualified.
- C. "Except for" qualified.
- D. Disclaimer of opinion.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The note presented describes an uncertainty that is properly disclosed. An explanatory paragraph is not required in the unqualified opinion.

Choice "b" is incorrect. A "subject to" qualified opinion should never be issued.

Choice "c" is incorrect. Since the auditor is satisfied that the assertion and disclosure are supported by the existing evidence, a qualified opinion is not required.

Choice "d" is incorrect. Since the auditor is satisfied that the assertion and disclosure are supported by the existing evidence, there is no need for the auditor to disclaim an opinion.

QUESTION 28

Kane, CPA, concludes that there is substantial doubt about Lima Co.'s ability to continue as a going concern for a reasonable period of time. If Lima's financial statements adequately disclose its financial difficulties, Kane's auditor's report is required to include an explanatory paragraph that specifically uses the phrase(s):



	<i><u>"Possible discontinuance of operations"</u></i>	<i><u>"Reasonable period of time, not to exceed one year"</u></i>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option CD. Option D

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion. This conclusion should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms "substantial doubt" and "going concern"]. The "reasonable period...not to exceed one year" is inherent in the definition of going concern and is not explicitly stated in the audit report. The phrase "possible discontinuation of operations" may be included in the going concern disclosure but is not specifically required. Choices "a", "b", and "c" are incorrect, as per the above explanation.

QUESTION 29

Mead, CPA, had substantial doubt about Tech Co.'s ability to continue as a going concern when reporting on Tech's audited financial statements for the year ended June 30, 19X4. That doubt has been removed in 19X5. What is Mead's reporting responsibility if Tech is presenting its financial statements for the year ended June 30, 19X5, on a comparative basis with those of 19X4?

- A. The explanatory paragraph included in the 19X4 auditor's report should not be repeated.
- B. The explanatory paragraph included in the 19X4 auditor's report should be repeated in its entirety.
- C. A different explanatory paragraph describing Mead's reasons for the removal of doubt should be included.
- D. A different explanatory paragraph describing Tech's plans for financial recovery should be included.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. If substantial doubt about the entity's ability to continue as a going concern has been removed in the current period, the explanatory paragraph included in the prior period auditor's report should not be repeated, and no description of the reasons or plans for recovery need be included.

Choice "b" is incorrect. If doubt about the going concern assumption has been removed in the current period, it is not appropriate to include the explanatory paragraph from the prior year in the auditor's report for the current year.

Choice "c" is incorrect. If doubt about the going concern assumption has been removed in the current period, no explanatory paragraph is required since the situation no longer exists. The auditor does not have to explain the reason for the change.

Choice "d" is incorrect. If doubt about the going concern assumption has been removed in the current period, no explanatory paragraph is required since the situation no longer exists. The entity does not have to describe its plans for the future.

QUESTION 30

March, CPA, is engaged by Monday Corp., a client, to audit the financial statements of Wall Corp., a company that is not March's client. Monday expects to present Wall's audited financial statements with March's auditor's report to 1st Federal Bank to obtain financing in Monday's attempt to purchase Wall. In these circumstances, March's auditor's report would usually be addressed to:

- A. Monday Corp., the client that engaged March.
- B. Wall Corp., the entity audited by March.
- C. 1st Federal Bank.
- D. Both Monday Corp. and 1st Federal Bank.

Correct Answer: A

Section: Auditing and Attestation Explanation



Explanation/Reference:

Explanation:

Choice "a" is correct. The auditors should address their report to the entity that engaged them. In this case, Monday Corp. engaged the auditor to perform an acquisition audit and the report should be addressed to Monday.

Choice "b" is incorrect. Wall Corp. did not engage the auditors and thus the report should not be addressed to them.

Choices "c" and "d" are incorrect. Even though the bank will be relying on the audited financial statements in determining whether to make the loan, the bank did not directly engage the auditing firm and accordingly, the report should not be addressed to them.

QUESTION 31

An auditor issued an audit report that was dual dated for a subsequent event occurring after the original date of the auditor's report but before issuance of the related financial statements. The auditor's responsibility for events occurring subsequent to the original report date was:

- A. Limited to include only events occurring up to the date of the last subsequent event referenced.
- B. Limited to the specific event referenced.
- C. Extended to subsequent events occurring through the later date.
- D. Extended to include all events occurring since the original report date.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. When an auditor issues a report that is dual dated for a subsequent event occurring after the original date of the auditor's report, but before issuance of the related financial statements, the auditor's responsibility for events occurring subsequent to the original report date is limited to the specific event referenced.

Choices "a", "c", and "d" are incorrect. The auditor takes responsibility for only the specific event noted in the dual dating and no other event occurring subsequent to the original report date.

QUESTION 32 When an independent CPA is associated with the financial statements of a publicly held entity but has not audited or reviewed such statements, the appropriate form of report to be issued must include a(an):

- A. Regulation S-X exemption.

- B. Report on pro forma financial statements.
- C. Unaudited association report.
- D. Disclaimer of opinion.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When an accountant is associated with the financial statements of a public entity, but has not audited or reviewed such statements, the accountant must issue a report disclaiming any opinion on the statements. Choices "a", "b", and "c" are incorrect since a disclaimer is required in this case.

QUESTION 33

Which of the following auditing procedures most likely would assist an auditor in identifying conditions and events that may indicate substantial doubt about an entity's ability to continue as a going concern?

- A. Inspecting title documents to verify whether any assets are pledged as collateral.
- B. Confirming with third parties the details of arrangements to maintain financial support.
- C. Reconciling the cash balance per books with the cut-off bank statement and the bank confirmation.
- D. Comparing the entity's depreciation and asset capitalization policies to other entities in the industry.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Confirming with third parties the details of arrangements to provide or "maintain (needed) financial support" is an audit procedure that may identify doubts about an entity's ability to continue as a going concern.

Choice "a" is incorrect. Inspecting title documents provides evidence of ownership of assets but would not necessarily identify conditions affecting an entity's ability to continue as a going concern.

Choice "c" is incorrect. Reconciling the cash balance per books with the cut-off bank statement and the bank confirmation provides evidence of completeness and valuation, but would not necessarily identify conditions affecting an entity's ability to continue as a going concern.

Choice "d" is incorrect. Comparing an entity's policies to other entities in the industry would not necessarily identify conditions affecting an entity's ability to continue as a going concern.

QUESTION 34

When an independent CPA assists in preparing the financial statements of a publicly held entity, but has not audited or reviewed them, the CPA should issue a disclaimer of opinion. In such situations, the CPA has no responsibility to apply any procedures beyond:

- A. Documenting that internal control is not being relied on.
- B. Reading the financial statements for obvious material misstatements.
- C. Ascertaining whether the financial statements are in conformity with GAAP.
- D. Determining whether management has elected to omit substantially all required disclosures.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The accountant is only required to read the financial statements for obvious material misstatements.

Choice "a" is incorrect. The accountant need not document that internal control is not being relied on.

Choices "c" and "d" are incorrect. The accountant is not required to evaluate conformity with GAAP, but any known departures (including inadequate disclosure) should be described in the disclaimer.

QUESTION 35

When an auditor concludes there is substantial doubt about a continuing audit client's ability to continue as a going concern for a reasonable period of time, the auditor's responsibility is to:

- A. Issue a qualified or adverse opinion, depending upon materiality, due to the possible effects on the financial statements.
- B. Consider the adequacy of disclosure about the client's possible inability to continue as a going concern.
- C. Report to the client's audit committee that management's accounting estimates may need to be adjusted.
- D. Reissue the prior year's auditor's report and add an explanatory paragraph that specifically refers to "substantial doubt" and "going concern."

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. When an auditor concludes there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, the auditor's responsibility is to consider the adequacy of disclosure about the entity's possible inability to continue as a going concern and include an explanatory paragraph in the audit report.

Choice "a" is incorrect. The auditor would include an explanatory paragraph following the unqualified opinion, or disclaim an opinion due to a material uncertainty. A qualified or adverse opinion is not appropriate for doubt about an entity's ability to continue as a going concern.

Choice "c" is incorrect. Management's accounting estimates are unrelated to going concern issues.

Choice "d" is incorrect. Going concern issues are considered prospectively. It is not appropriate to reissue a prior audit report if doubt arises about an entity's ability to continue in a future period.

QUESTION 36

Reference in a principal auditor's report to the fact that part of the audit was performed by another auditor most likely would be an indication of the:

- A. Divided responsibility between the auditors who conducted the audits of the components of the overall financial statements.
- B. Lack of materiality of the portion of the financial statements audited by the other auditor.
- C. Principal auditor's recognition of the other auditor's competence, reputation, and professional certification.
- D. Different opinions the auditors are expressing on the components of the financial statements that each audited.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Reference to another auditor indicates division of responsibility for the audits of the components of the overall financial statements.

Choice "b" is incorrect. Reference to another auditor would not generally be made if the other auditor's portion of the financial statements were immaterial.

Choice "c" is incorrect. The reference in the report is not meant to recognize the qualifications of the other auditor, but simply to divide the responsibility between the two auditors. Choice "d" is incorrect. The reference to the other auditor would be made regardless of what type of opinion is expressed by each auditor.

QUESTION 37 An auditor includes a separate paragraph in an otherwise unmodified report to emphasize that the entity being reported on had significant transactions with related parties. The inclusion of this separate paragraph:

- A. Is considered an "except for" qualification of the opinion.
- B. Violates generally accepted auditing standards if this information is already disclosed in footnotes to the financial statements.
- C. Necessitates a revision of the opinion paragraph to include the phrase "with the foregoing Explanation: ."
- D. Is appropriate and would not negate the unqualified opinion.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Emphasis of a matter should be disclosed in an explanatory paragraph appended to an otherwise unqualified opinion.

Choice "a" is incorrect. An "except for" qualification is used for a scope limitation or a departure from GAAP, but not for emphasis of a matter.

Choice "b" is incorrect. The auditor may emphasize a matter even if it is included in the footnotes.

Choice "c" is incorrect. A phrase such as "with the foregoing Explanation: " should not be used in an unqualified opinion.

QUESTION 38

When there has been a change in accounting principles, but the effect of the change on the comparability of the financial statements is not material, the auditor should:

- A. Refer to the change in an explanatory paragraph.
- B. Explicitly concur that the change is preferred.
- C. Not refer to consistency in the auditor's report.
- D. Refer to the change in the opinion paragraph.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. If an accounting change has no material effect on the comparability of the financial statements, the auditor does not need to recognize the change in the current year's audit report. Choice

"a" is incorrect. The change would only be referred to in an explanatory paragraph if the effect were material.

Choice "b" is incorrect. The auditor does not explicitly concur with the change in the report.

Choice "d" is incorrect. Even if the change had a material effect, the opinion paragraph would not be affected. The explanatory paragraph would follow the opinion paragraph.

QUESTION 39

When single-year financial statements are presented, an auditor ordinarily would express an unqualified opinion in an unmodified report if the:

- A. Auditor is unable to obtain audited financial statements supporting the entity's investment in a foreign affiliate.
- B. Entity declines to present a statement of cash flows with its balance sheet and related statements of income and retained earnings.
- C. Auditor wishes to emphasize an accounting matter affecting the comparability of the financial statements with those of the prior year.
- D. Prior year's financial statements were audited by another CPA whose report, which expressed an unqualified opinion, is not presented.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Since only single-year financial statements are presented, the fact that another CPA audited the prior year's financial statements is not relevant. Therefore, the auditor would express an unqualified opinion in an unmodified report.

Choice "a" is incorrect. The situation described would result in a qualified opinion or disclaimer of opinion due to a scope limitation.

Choice "b" is incorrect. The situation described would result in a qualified opinion due to inadequate disclosure.

Choice "c" is incorrect. The situation described would result in an otherwise unqualified opinion modified by adding an additional explanatory paragraph after the opinion paragraph.

QUESTION 40

Park, CPA, was engaged to audit the financial statements of Tech Co., a new client, for the year ended December 31, 20X3. Park obtained sufficient audit evidence for all of Tech's financial statement items except Tech's opening inventory. Due to inadequate financial records, Park could not verify Tech's January 1, 20X3, inventory balances. Park's opinion on Tech's 20X3 financial statements most likely will be:

Balance sheet	Income statement
A. Disclaimer	Disclaimer
B. Unqualified	Disclaimer
C. Disclaimer	Adverse
D. Unqualified	Adverse

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. When the auditor is unable to satisfy himself or herself regarding the amount of beginning inventory, he or she must disclaim an opinion on the income statement because of the inability to verify the cost of goods sold during the year. The auditor may, however, still be able to issue an unqualified opinion on the balance sheet, since inventory can be verified as of the balance sheet date. Choices "a", "c", and "d" are incorrect, based on the explanation above.

QUESTION 41 Which paragraphs of an auditor's standard report on financial statements should refer to generally accepted auditing standards (GAAS) and generally accepted accounting principles (GAAP)?

- A. Option A

- B. Option B
- C. Option C
- D. Option D

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The auditor states that the audit was conducted in accordance with GAAS in the scope paragraph. The auditor expresses an opinion on the financial statements' conformity with GAAP in the opinion paragraph. Choices "a", "b", and "d" are incorrect, per the above explanation.

QUESTION 42

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.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. An adverse opinion is issued when the financial statements are not presented in accordance with GAAP.

Choice "a" is incorrect. The client's refusal to provide access to the minutes of the Board of Directors' meetings would result in a disclaimer of opinion.

Choice "b" is incorrect. If internal control is so poor that it cannot be relied upon, the auditor must consider the effect on the audit procedures and subsequent report, but would not issue an adverse opinion.

Choice "d" is incorrect. Substantial doubt with regard to the entity's ability to continue as a going concern should be disclosed in an additional explanatory paragraph appended to an otherwise unqualified opinion.

QUESTION 43

When disclaiming an opinion due to a client-imposed scope limitation, an auditor should indicate in a separate paragraph why the audit did not comply with generally accepted auditing standards. The auditor should also omit the:

	<u>Scope paragraph</u>	<u>Opinion paragraph</u>
A.	No	Yes
B.	Yes	Yes
C.	No	No
D.	Yes	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When disclaiming an opinion because of scope limitations, the auditor should indicate in a separate paragraph(s) the reasons that the audit did not comply with GAAS. The auditor should also omit the scope paragraph. The opinion paragraph is not omitted; however, it indicates that no opinion is expressed. Choices "a", "b", and "c" are incorrect, as per the above explanation.

QUESTION 44

An auditor decides to issue a qualified opinion on an entity's financial statements because a major inadequacy in its computerized accounting records prevents the auditor from applying necessary procedures. The opinion paragraph of the auditor's report should state that the qualification pertains to:

- A. A client-imposed scope limitation.
- B. A departure from generally accepted auditing standards.
- C. The possible effects on the financial statements.
- D. Inadequate disclosure of necessary information.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. When an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself.

Choice "a" is incorrect. When an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself.

Choice "b" is incorrect. A scope limitation is a departure from generally accepted auditing standards.

However, when an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself.

Choice "d" is incorrect. Inadequate disclosure of necessary information is a departure from GAAP, rather than a scope limitation.

QUESTION 45

When an auditor qualifies an opinion because of inadequate disclosure, the auditor should describe the nature of the omission in a separate explanatory paragraph and modify the:

	<u>Introductory paragraph</u>	<u>Scope paragraph</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No



- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. In a report qualified for inadequate disclosure, the auditor would add an explanatory paragraph and modify the opinion paragraph, but the introductory and scope paragraphs would not be modified. Choices "a", "b", and "c" are incorrect, as per the above explanation.

QUESTION 46

An entity changed from the straight-line method to the declining balance method of depreciation for all newly acquired assets. This change has no material effect on the current year's financial statements, but is reasonably certain to have a substantial effect in later years. If the change is disclosed in the notes to the financial statements, the auditor should issue a report with a(an):

- A. "Except for" qualified opinion.
- B. Explanatory paragraph.
- C. Unqualified opinion.
- D. Consistency modification.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. If an accounting change has no material effect on the financial statements in the current year, but a material future effect, the auditor must ensure that the change is disclosed in the footnotes whenever the financial statements of the change period are presented, but does not have to recognize the change in the current year's audit report.

Choice "a" is incorrect. Accounting changes that are accounted for properly do not result in qualified opinions.

Choices "b" and "d" are incorrect. A consistency modification (explanatory paragraph) is not necessary when the effect of a change is immaterial.

QUESTION 47 If a publicly held company issues financial statements that purport to present its financial position and results of operations but omits the statement of cash flows, the auditor ordinarily will express a(an):

- A. Disclaimer of opinion.
- B. Qualified opinion.
- C. Review report.
- D. Unqualified opinion with a separate explanatory paragraph.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. If a company issues financial statements that purport to present financial position and results of operations but omits the related statement of cash flows, the auditor will normally conclude that the omission requires qualification of the opinion.

Choice "a" is incorrect. If the company fails to present its statement of cash flows, this is considered inadequate disclosure. The auditor would not issue a disclaimer of opinion for inadequate disclosure. Choice "c" is incorrect. The auditor would not issue a review report when performing an audit.

Choice "d" is incorrect. The auditor cannot issue an unqualified report if the client omits a statement of cash flows from the financial statements.

QUESTION 48

In which of the following circumstances would an auditor most likely add an explanatory paragraph to the standard report while not affecting the auditor's unqualified opinion?

- A. The auditor is asked to report on the balance sheet, but not on the other basic financial statements.
- B. There is substantial doubt about the entity's ability to continue as a going concern.
- C. Management's estimates of the effects of future events are unreasonable.
- D. Certain transactions cannot be tested because of management's records retention policy.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph to reflect that conclusion.

Choice "a" is incorrect. Reporting on just the balance sheet is acceptable provided access to financial information is not limited. Such reporting does not require an explanatory paragraph.

Choice "c" is incorrect. If the auditor concludes that management's estimate is unreasonable and that its effect is to cause the financial statements to be materially misstated, the auditor should express a qualified or an adverse opinion. Choice "d" is incorrect. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, may require the auditor to qualify or to disclaim an opinion.

QUESTION 49

When an entity changes its method of accounting for income taxes, which has a material effect on comparability, the auditor should refer to the change in an explanatory paragraph added to the auditor's report. This paragraph should identify the nature of the change and:

- A. Explain why the change is justified under generally accepted accounting principles.
- B. Describe the cumulative effect of the change on the audited financial statements.
- C. State the auditor's explicit concurrence with or opposition to the change.
- D. Refer to the financial statement note that discusses the change in detail.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The paragraph should refer to the note in the financial statements that discusses the change in detail. Following is an example of an appropriate explanatory paragraph: "As discussed in Note X to the financial statements, the company changed its method of accounting for income taxes in X2."

Choice "a" is incorrect. The auditor need not explain why a change from one generally accepted accounting principle to another is justified.

Choice "b" is incorrect. The paragraph should not identify the cumulative effect of the change on the audited financial statements.

Choice "c" is incorrect. The auditor should never explicitly state concurrence with a change. If the auditor opposes the change, a qualified or adverse opinion should be issued.

QUESTION 50

Green, CPA, was engaged to audit the financial statements of Essex Co. after its fiscal year had ended. The timing of Green's appointment as auditor and the start of fieldwork made confirmation of accounts receivable by direct communication with the debtors ineffective. However, Green applied other procedures and was satisfied as to the reasonableness of the account balances. Green's auditor's report most likely contained a(an):

- A. Unqualified opinion.
- B. Unqualified opinion with an explanatory paragraph.
- C. Qualified opinion due to a scope limitation.
- D. Qualified opinion due to a departure from generally accepted auditing standards.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. There is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless accounts receivable are immaterial, the use of confirmations would be ineffective, or the assessed inherent risk is so low that the evidence expected to be provided by analytical procedures or other substantive tests of details would be sufficient. In this example, the confirmation of accounts receivable by direct communication with the debtors would be ineffective. If Green was able to apply alternative audit procedures and was satisfied as to the reasonableness of the account balances, then an unqualified opinion could be issued.

Choice "b" is incorrect. Since Green was satisfied as far as the accounts receivable balances, there is no need to add an explanatory paragraph.

Choice "c" is incorrect. Since Green was able to perform alternative procedures and was satisfied as far as the reasonableness of the account balances, there is no scope limitation.

Choice "d" is incorrect. Since Green was able to perform alternative procedures and was satisfied as far as the reasonableness of the account balances, there is no departure from generally accepted auditing standards.

QUESTION 51

Which of the following is not true regarding an engagement to provide a written report on the application of accounting principles?

- A. An accountant is prohibited from providing a report on the application of accounting principles to a transaction not involving the facts and circumstances of a specific entity.
- B. The accountant's written report on the application of accounting principles should include an identification of the specific entity involved.
- C. An accountant is prohibited from providing a report on the application of accounting principles to a proposed future transaction involving the facts and circumstances of a specific entity.
- D. The accountant's written report on the application of accounting principles should include a paragraph restricting the use of the report.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. An accountant may report on the application of accounting principles to a proposed future transaction as long as the transaction involves the facts and circumstances of a specific entity.

Choice "a" is incorrect. An accountant is prohibited from providing a report on the application of accounting principles to "hypothetical transactions," which are defined as those not involving the facts and circumstances of a specific entity.

Choices "b" and "d" are incorrect. The accountant's written report on the application of accounting principles should include an identification of the specific entity involved, a description of the transaction(s), a statement of the relevant facts, circumstances, and assumptions (and a statement that any changes therein may change the report), a statement about the source of the information, a statement describing the appropriate accounting principles or type of opinion that may be rendered, the reasons for the accountant's conclusions, a statement regarding management's responsibility, and a restrictive use paragraph.

QUESTION 52

Before reporting on the financial statements of a U.S. entity that have been prepared in conformity with another country's accounting principles, an auditor practicing in the U.S. should:

- A. Understand the accounting principles generally accepted in the other country.
- B. Be certified by the appropriate auditing or accountancy board of the other country.
- C. Notify management that the auditor is required to disclaim an opinion on the financial statements.
- D. Receive a waiver from the auditor's state board of accountancy to perform the engagement.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Before reporting on the financial statements of a U.S. entity that have been prepared in conformity with another country's accounting principles, the auditor practicing in the U.S. should understand the accounting principles generally accepted in the other country.

Choice "b" is incorrect. The auditor practicing in the U.S. would be able to report on the financial statements of the U.S. entity without obtaining certification in the other country.

Choice "c" is incorrect. The auditor need not disclaim an opinion on the financial statements prepared in conformity with another country's accounting principles. Choice "d" is incorrect. A waiver to perform the engagement is not necessary.

QUESTION 53

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.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The accountant's report on the application of accounting principles should include a statement that should any facts or circumstances differ from those presented to the accountant, the accountant's conclusions may change.

Choice "b" is incorrect. The report should state that the engagement was performed in accordance with "AICPA Standards," not statements on Standards for Consulting Services.

Choice "c" is incorrect. The report's use is restricted to "specified parties," which may include parties other than management (e.g., the board of directors). Also, the preparers of the financial statements and the reporting accountant should consult with the entity's continuing accountant.

Choice "d" is incorrect. The report does not provide negative assurance with respect to GAAP; rather, it may describe the appropriate accounting principles to be applied.

QUESTION 54

Blue, CPA, has been asked to render an opinion on the application of accounting principles to a specific transaction by an entity that is audited by another CPA. Blue may accept this engagement, but should:

- A. Consult with the continuing CPA to obtain information relevant to the transaction.
- B. Report the engagement's findings to the entity's audit committee, the continuing CPA, and management.
- C. Disclaim any opinion that the hypothetical application of accounting principles conforms with generally accepted accounting principles.
- D. Notify the entity that the report is for the general use of all interested parties.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. When rendering an opinion on the application of accounting principles to a specific transaction, the reporting CPA should consult with the continuing CPA to obtain information relevant to the transaction.

Choice "b" is incorrect. The reporting CPA has no obligation to report the engagement's findings to the continuing CPA. Generally, the report would be addressed to the requesting party (e.g., management, the board of directors, etc.).

Choice "c" is incorrect. There is no disclaimer in the report; however, the CPA does state that the preparers of the financial statements are responsible for proper accounting treatment. Choice "d" is incorrect. Use of the report is restricted to specified parties.

QUESTION 55

The financial statements of KCP America, a U.S. entity, are prepared for inclusion in the consolidated financial statements of its non-U.S. parent. These financial statements are prepared in conformity with the accounting principles generally accepted in the parent's country and are for use only in that country.

How may KCP America's auditor report on these financial statements?

- I. A U.S.-style report (unmodified).
- II. A U.S.-style report modified to report on the accounting principles of the parent's country.
- III. The report form of the parent's country.

	<u>I</u>	<u>II</u>	<u>III</u>
A.	Yes	No	No
B.	No	Yes	No
C.	Yes	No	Yes
D.	No	Yes	Yes

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. No - Yes - Yes. When financial statements are prepared in conformity with the accounting principles generally accepted in the parent's country and are for use only in that country, the auditor may report using either a U.S.-style report modified to report on the accounting principles of the parent's country or the report form of the parent's country. Choices "a", "b", and "c" are incorrect, per the above explanation.

QUESTION 56

Which of the following is true regarding the auditor's responsibility to report on information accompanying the basic financial statements in a client-prepared document?

- A. The auditor may report on information accompanying the basic financial statements in a client-prepared document only if he or she has been specifically engaged to do so.
- B. The auditor is required to express an opinion on whether information accompanying the basic financial statements in a client-prepared document is fairly stated in all material respects in relation to the financial statements taken as a whole.
- C. If an auditor chooses to report on information accompanying the basic financial statements in a client-prepared document, the report should include a description of the character of the audit work performed.
- D. If an auditor chooses to report on information accompanying the basic financial statements in a client-prepared document, the report should include an opinion on the information but should not describe the character of the audit work performed.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. If an auditor chooses to report on information accompanying the basic financial statements in a client-prepared document, the report should include a description of both the character of the audit work performed and the degree of responsibility assumed.

Choice "a" is incorrect. There is no requirement that the auditor be specifically engaged to report on such information. If auditing procedures have been applied to the information, the auditor is permitted to report thereon.

Choice "b" is incorrect. The auditor is permitted but not required to report on such information.

Choice "d" is incorrect. If an auditor chooses to report on information accompanying the basic financial statements in a client-prepared document, the report should include an opinion on the information and a description of both the character of the audit work performed and the degree of responsibility assumed.

QUESTION 57

Which of the following reporting options is least likely with regard to supplementary information that is required by GAAP?

- A. The auditor's report on the financial statements makes no reference to the supplementary information.
- B. A disclaimer of opinion is issued on supplementary information that is not clearly distinguished from the financial statements and is not marked "unaudited."
- C. The auditor's report on the financial statements includes both an opinion on the supplementary information and a statement restricting the use of the report.
- D. The auditor's report on the financial statements includes an opinion regarding whether the supplementary information is fairly stated in all material respects in relation to the financial statements taken as a whole.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. There is no requirement that the auditor's report on supplementary information required by GAAP be restricted.

Choice "a" is incorrect. An auditor is not required to audit supplementary information, and in such cases the auditor's report on the basic financial statements would not generally include a reference to such information.

Choice "b" is incorrect. When supplementary information that is not clearly distinguished from the financial statements is not marked "unaudited," the auditor would generally issue a disclaimer on that information.

Choice "d" is incorrect. When the auditor chooses to apply auditing procedures to the supplementary information, he or she may express an opinion regarding whether the supplementary information is fairly stated in all material respects in relation to the financial statements taken as a whole.

QUESTION 58

When an auditor submits a document containing audited financial statements to a client, and those financial statements include supplementary information required by GAAP, the auditor may choose any of the following options, except:

- A. Express an opinion on the information, if he or she has been engaged to examine such information.
- B. Express negative assurance on the information, if review procedures have been appropriately performed.
- C. Report on whether the information is fairly stated in relation to the financial statements taken as a whole, if appropriate auditing procedures have been applied.
- D. Disclaim an opinion on the information.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The auditor would not perform a review or express negative assurance on supplementary information required by GAAP that is included in an auditor-submitted document.

Choice "a" is incorrect. The auditor may express an opinion on the information, if he or she has been engaged to examine it.

Choice "c" is incorrect. The auditor may report on whether the information is fairly stated in relation to the financial statements taken as a whole, if appropriate auditing procedures have been applied. Choice "d" is incorrect. The auditor may disclaim an opinion on the information.

QUESTION 59

An auditor may report on condensed financial statements that are derived from complete financial statements if the:

- A. Condensed financial statements are distributed to stockholders along with the complete financial statements.
- B. Auditor describes the additional procedures performed on the condensed financial statements.
- C. Auditor indicates whether the information in the condensed financial statements is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.
- D. Condensed financial statements are presented in comparative form with the prior year's condensed financial statements.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. An auditor may report on condensed financial statements that are derived from financial statements that he or she has audited, indicating (1) that he or she has audited and expressed an opinion on the complete financial statements, (2) the date of the auditor's report, (3) the type of opinion expressed, and (4) that the information contained in the condensed financial statements is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.

Choice "a" is incorrect. The condensed financial statements do not have to be distributed to the stockholders.

Choice "b" is incorrect. The audit report on condensed financial statements does not require that additional procedures be described.

Choice "d" is incorrect. Condensed financial statements do not need to be presented in comparative form with the prior year's financial statements.

QUESTION 60 An auditor is engaged to report on selected financial data that are included in a client-prepared document containing audited financial statements. Under these circumstances, the report on the selected data should:

- A. Be limited to data derived from the audited financial statements.
- B. Be distributed only to senior management and the board of directors.
- C. State that the presentation is a comprehensive basis of accounting other than GAAP.
- D. Indicate that the data are not fairly stated in all material respects.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. An auditor's report on selected information included in a client-prepared document containing audited financial statements should be limited to data derived from audited financial statements. Choice

"b" is incorrect. It is not necessary to limit distribution of such a report.

Choice "c" is incorrect. Selected financial data is not an "other comprehensive basis of accounting."

Choice "d" is incorrect. The auditor indicates whether the selected financial data is fairly stated, in all material respects, in relation to the financial statements from which it has been derived.

QUESTION 61

If information accompanying the basic financial statements in an auditor-submitted document has been subjected to auditing procedures, the auditor may include in the auditor's report on the financial statements an opinion that the accompanying information is fairly stated in:

- A. Accordance with generally accepted auditing standards.
- B. Conformity with generally accepted accounting principles.
- C. All material respects in relation to the basic financial statements taken as a whole.
- D. Accordance with attestation standards expressing a conclusion about management's assertions.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. When an auditor submits a document that contains information in addition to the client's basic financial statements, and this information was subjected to auditing procedures, the auditor may include in the auditor's report an opinion that the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole. This statement would follow the opinion paragraph in the standard report.

Choice "a" is incorrect. Information in an ASD is not stated in an auditor's report to be in accordance with GAAS. Instead, the auditor would state that the "information has been subjected to the auditing procedures applied in the audit of the basic financial statements..."

Choice "b" is incorrect. The auditor would not state that ASD information was fairly stated in accordance with GAAP. The information in an ASD is in addition to that required by GAAP.

Choice "d" is incorrect. Reports on ASD are not "attest engagements."

QUESTION 62

An auditor concludes that there is a material inconsistency in the other information in an annual report to shareholders containing audited financial statements. The auditor believes that the financial statements do not require revision, but the client is unwilling to revise or eliminate the material inconsistency in the other information. Under these circumstances, what action would the auditor most likely take?

- A. Consider the situation closed because the other information is not in the audited financial statements.
- B. Issue an "except for" qualified opinion after discussing the matter with the client's audit committee.
- C. Disclaim an opinion on the financial statements after explaining the material inconsistency in a separate explanatory paragraph.
- D. Revise the auditor's report to include a separate explanatory paragraph describing the material inconsistency.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. If the auditor discovers a material inconsistency in other information accompanying the audited financial statements, the financial statements do not require revision, and the client refuses to eliminate or revise the inconsistency, the auditor should consider 1) revising the report to include a separate paragraph describing the inconsistency, 2) withholding the report, or 3) withdrawing from the engagement.

Choice "a" is incorrect. Even though the auditor has no responsibility to audit or otherwise corroborate other information accompanying the financial statements, the auditor has a responsibility to read the other information accompanying the financial statements for consistency and to identify any material misstatements of fact included therein.

Choice "b" is incorrect. A qualified opinion is generally not warranted because the financial statements are fairly stated. Choice

"c" is incorrect. A disclaimer of opinion is generally not warranted because there is no limitation on scope.

QUESTION 63

In the standard report on condensed financial statements that are derived from a public entity's audited financial statements, a CPA should indicate that the:

- A. Condensed financial statements are prepared in conformity with another comprehensive basis of accounting.
- B. CPA has audited and expressed an opinion on the complete financial statements.
- C. Condensed financial statements are not fairly presented in all material respects.
- D. CPA expresses limited assurance that the financial statements conform with GAAP.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The auditor's report on condensed statements derived from audited statements should indicate (1) that the CPA audited and expressed an opinion on the complete financial statements, (2) the date of the auditor's report on the complete financial statements, (3) the type of opinion expressed, and (4) whether, in the auditor's opinion, the information set forth in the condensed financial statements is fairly stated in all material respects in relation to the complete financial statements from which it was derived.

Choice "a" is incorrect. Condensed financial statements are not prepared in conformity with a comprehensive basis of accounting other than GAAP.

Choice "c" is incorrect. The auditor's report on condensed financial statements does not indicate whether they are fairly presented in all material respects; rather, the report indicates whether they are fairly presented in relation to the complete financial statements.

Choice "d" is incorrect. The auditor does not express an opinion (or provide any assurance) on whether condensed FS conform with GAAP; only whether such statements are fairly stated in relation to the complete FS.

QUESTION 64

Investment and property schedules are presented for purposes of additional analysis in an auditor submitted document. The schedules are not required parts of the basic financial statements, but accompany the basic financial statements. When reporting on such additional information, the measurement of materiality is the:

- A. Same as that used in forming an opinion on the basic financial statements taken as a whole.
- B. Lesser of the individual schedule of investments or schedule of property taken by itself.
- C. Greater of the individual schedule of investments or schedule of property taken by itself.
- D. Combined total of both the individual schedules of investments and property taken as a whole.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. When reporting on additional information accompanying the audited financial statements, the measure of materiality would be the same as that used in forming an opinion on the financial statements taken as a whole.

Choices "b", "c", and "d" are incorrect, based on the above explanation.

QUESTION 65

What is an auditor's responsibility for supplementary information which is outside the basic financial statements, but required by the FASB?

- A. The auditor has no responsibility for required supplementary information as long as it is outside the basic financial statements.
- B. The auditor's only responsibility for required supplementary information is to determine that such information has not been omitted.
- C. The auditor should apply certain limited procedures to the required supplementary information, and report deficiencies in, or omissions of, such information.
- D. The auditor should apply tests of details of transactions and balances to the required supplementary information, and report any material misstatements in such information.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. For additional supplementary information required by the FASB, the auditor should apply certain limited procedures to the information, and report deficiencies in or omissions of such information.

Choice "a" is incorrect. Required supplementary information is considered an essential part of financial reporting, and therefore certain limited procedures should be applied by the auditor.

Choice "b" is incorrect. For additional supplementary information required by the FASB, the auditor should apply certain limited procedures to the information, and report deficiencies in or omissions of such information. Choice "d" is incorrect. Certain limited procedures should be applied to required supplementary information, but this information need not be audited.

QUESTION 66

Which of the following best describes the auditor's reporting responsibility concerning information accompanying the basic financial statements in an auditor-submitted document?

- A. The auditor has no reporting responsibility concerning information accompanying the basic financial statements.
- B. The auditor should report on the information accompanying the basic financial statements only if the auditor participated in its preparation.
- C. The auditor should report on the information accompanying the basic financial statements only if the auditor did not participate in its preparation.
- D. The auditor should report on all the information included in the document.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When an auditor submits a document containing audited financial statements to the client or others, the auditor has a responsibility to report on all the information included in the document.

Choice "a" is incorrect. The auditor does have additional reporting responsibilities concerning information that accompanies the basic financial statements in an auditor-submitted document.
Choice "b" is incorrect. The auditor has responsibility to report on any additional information regardless of whether the auditor participated in the preparation of the information. Choice "c" is incorrect. The auditor has reporting responsibilities regardless of whether the auditor participated in the preparation of the information.

QUESTION 67

When audited financial statements are presented in a client's document containing other information, the auditor should:

- A. Perform inquiry and analytical procedures to ascertain whether the other information is reasonable.
- B. Add an explanatory paragraph to the auditor's report without changing the opinion on the financial statements.
- C. Perform the appropriate substantive auditing procedures to corroborate the other information.
- D. Read the other information to determine that it is consistent with the audited financial statements.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The auditor should read the "other information" in a client's document containing audited FS to determine that it is consistent with the audited FS.
Choice "a" is incorrect. Performing analytical procedures or any other procedure is not necessary. Choice "b" is incorrect. An explanatory paragraph is not required.
Choice "c" is incorrect. The auditor has no obligation to perform any procedure to corroborate "other information" contained in a document such as an annual report.

QUESTION 68

An auditor may report on condensed financial statements that are derived from complete audited financial statements if the:

- A. Auditor indicates whether the information in the condensed financial statements is fairly stated in all material respects.
- B. Condensed financial statements are presented in comparative form with the prior year's condensed financial statements.
- C. Auditor describes the additional review procedures performed on the condensed financial statements.
- D. Condensed financial statements are distributed only to management and the board of directors.

Correct Answer: A

Section: Auditing and Attestation Explanation

**Explanation/Reference:**

Explanation:

Choice "a" is correct. When reporting on condensed financial statements that are derived from complete audited financial statements, the auditor should indicate in his report whether the information in the condensed financial statements is fairly stated in all material respects (in relation to the basic financial statements taken as a whole).
Choices "b" and "d" are incorrect. There is no requirement that the condensed financial statements be presented in comparative form, or that they be distributed only to management and the board of directors (i.e., distribution is not restricted).
Choice "c" is incorrect. The auditor would not perform or describe additional review procedures related to the condensed financial statements.

QUESTION 69 If management (of a governmental body) declines to present supplementary information required by the Governmental Accounting Standards Board (GASB), the auditor should issue a(an):

- A. Adverse opinion.
- B. Qualified opinion with an explanatory paragraph.
- C. Unqualified opinion.
- D. Unqualified opinion with an additional explanatory paragraph.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. If management (of a governmental body) declines to present information required by the GASB, the auditor should issue an unqualified opinion with an additional explanatory paragraph. Choices "a", "b", and "c" are incorrect, per the above explanation.

QUESTION 70

The objective of auditing procedures applied to segment information is to provide the auditor with a reasonable basis for concluding whether:

- A. The information is useful for comparing a segment of one enterprise with a similar segment of another enterprise.

- B. Sufficient audit evidence has been obtained to allow the auditor to be associated with the segment information.
- C. A separate opinion on the segment information is necessary due to inconsistent application of accounting principles.
- D. The information is presented in conformity with the FASB Statement on segment information.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The auditor's objective is to provide a reasonable basis for concluding whether segment information is presented in conformity with GAAP.

Choice "a" is incorrect. The auditor is not required to see that segment information included is comparable to other enterprises.

Choice "b" is incorrect. Sufficient audit evidence must be obtained to ensure that segment information is presented in accordance with GAAP, not to allow the auditor to be associated with such information. Choice

"c" is incorrect. The inclusion of segment information is a GAAP requirement, and a separate opinion is not required.

QUESTION 71

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

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

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A "reporting accountant" (an accountant in public practice who is requested to render an opinion on the application of GAAP by an entity audited by another CPA) may accept the engagement, but should consult with the "continuing CPA" to ascertain the available facts relevant to forming a professional judgment.

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

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

QUESTION 72

In its annual report to shareholders, Lake Co. included a separate management report that contained additional information. Lake's auditor is expressing an unqualified opinion on Lake's financial statements but has not been engaged to examine and report on this additional information. What is the auditor's responsibility concerning such a report?

- A. The auditor should add an explanatory paragraph to the report on the financial statements disclaiming an opinion on the additional information.
- B. The auditor has no obligation to read the management report or to verify the accuracy or appropriateness of its contents.
- C. The auditor should request Lake to place the management report in its annual report where it will not be misinterpreted to be the auditor's assertion.
- D. The auditor should read the management report and consider whether it contains a material misstatement of fact.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The auditor should read other information accompanying the basic financial statements and consider whether it contains a material inconsistency or material misstatement of fact.

Choice "a" is incorrect. The auditor generally does not add a disclaimer paragraph in this situation.

Choice "b" is incorrect. The auditor should read other information accompanying the basic financial statements and consider whether it contains a material inconsistency or material misstatement of fact.

Choice "c" is incorrect. Even if the management report were included in the annual report, the auditor still has the same responsibility regarding both the management report and the annual report: the auditor should read the information and consider whether it contains a material inconsistency or material misstatement of fact.

QUESTION 73

An auditor is reporting on condensed financial statements for an annual period that are derived from the audited financial statements of a publicly-held entity. The auditor's opinion should indicate whether the information in the condensed financial statements is fairly stated in all material respects:

- A. In conformity with accounting principles generally accepted in the United States of America.
- B. In relation to the complete financial statements.

- C. In conformity with another comprehensive basis of accounting.
- D. In relation to supplementary filings under federal security statutes.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The auditor should report whether the information in the condensed financial statements is fairly stated, in all material respects, in relation to the financial statements from which it has been derived.

Choice "a" is incorrect. Condensed financial statements do not include all of the disclosures required by GAAP, and therefore would not typically be presented in conformity with GAAP.

Choice "c" is incorrect. Condensed financial statements are presented in less detail than complete financial statements, but the fact pattern gives no indication that any comprehensive basis of accounting other than GAAP has been used.

Choice "d" is incorrect. The auditor should report whether the information in the condensed financial statements is fairly stated, in all material respects, in relation to the financial statements from which it has been derived, not in relation to supplementary filings under federal security statutes.

QUESTION 74

An auditor determines that the entity is presenting certain supplementary financial disclosures of pension information that are required by the GASB. Under these circumstances, the auditor should:

- A. Add an explanatory paragraph to the auditor's report that refers to the required supplementary information.
- B. State that the audit is not being performed in accordance with generally accepted auditing standards.
- C. Document in the working papers that the required supplementary information is presented, but should not apply any procedures to the information.
- D. Compare the required supplementary information for consistency with the audited financial statements.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The auditor should perform certain limited procedures on supplementary information accompanying the financial statements, including evaluating whether the information is consistent with the audited financial statements.

Choice "a" is incorrect. Generally, the auditor's report on the financial statements would not include a reference to required supplementary information unless there were a problem with it (e.g., it was omitted, inappropriately prepared, or the auditor was unable to satisfactorily complete required procedures).

Choice "b" is incorrect. An audit can and should be performed in accordance with generally accepted auditing standards even when required supplementary information is presented. Choice

"c" is incorrect. The auditor should perform certain limited procedures on supplementary information accompanying the financial statements.

QUESTION 75

An auditor reads the letter of transmittal accompanying a county's comprehensive annual financial report and identifies a material inconsistency with the financial statements. The auditor determines that the financial statements do not require revision. Which of the following actions should the auditor take?

- A. Request that the client revise the letter of transmittal.
- B. Include an explanatory paragraph in the auditor's report.
- C. Consider withdrawing from the engagement.
- D. Request a client representation letter acknowledging the inconsistency.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. When information accompanies audited financial statements in a client-prepared document, the auditor is required to read the information. If such information is materially inconsistent with the financial statements and the financial statements do not require revision, the auditor should request that the information (in this case the letter of transmittal) be revised.

Choice "b" is incorrect. The auditor would only revise the report to include discussion of the material inconsistency if the client were unwilling to revise the transmittal letter appropriately.

Choice "c" is incorrect. The auditor would only consider withdrawing from the engagement if the client were unwilling to revise the transmittal letter appropriately.

Choice "d" is incorrect. The auditor would not request a client representation letter acknowledging the inconsistency, as correction (and not simply acknowledgment) of the error is desired.

QUESTION 76

Pell, CPA, decides to serve as principal auditor in the audit of the financial statements of Tech Consolidated, Inc. Smith, CPA, audits one of Tech's subsidiaries. In which situation(s) should Pell make reference to Smith's audit?

- I. Pell reviews Smith's audit documentation and assumes responsibility for Smith's work, but expresses a qualified opinion on Tech's financial statements.
- II. Pell is unable to review Smith's audit documentation; however, Pell's inquiries indicate that Smith has an excellent reputation for professional competence and integrity.

- A. I only
- B. II only
- C. Both I and II
- D. Neither I nor II

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. II only. If Pell is unable to review Smith's audit documentation, but inquiries indicate that Smith has an excellent reputation for professional competence and integrity, Pell should divide responsibility by making reference to Smith's audit.

Choices "a", "c", and "d" are incorrect. Since the principal auditor in situation I reviews Smith's audit documentation and assumes responsibility for Smith's work, no mention of Smith should be made.

QUESTION 77

Which of the following best describes what is meant by the term generally accepted auditing standards?

- A. Rules acknowledged by the accounting profession because of their universal application.
- B. Pronouncements issued by the Auditing Standards Board.
- C. Measures of the quality of the auditor's performance.
- D. Procedures to be used to gather evidence to support financial statements.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Generally accepted auditing standards ("GAAS") are measures of the quality of the auditor's performance.

Choice "a" is incorrect. GAAS are not "rules," nor are they universally applicable. GAAS are measures of the quality of an auditor's performance.

Choice "b" is incorrect. The Auditing Standards Board (ASB) issues many types of pronouncements, including (but not limited to) "Statements on Auditing Standards" (SASs). While SASs are considered to be interpretations of GAAS, not all ASB pronouncements relate to audits. Therefore, just because something is issued by the ASB does not make it GAAS.

Choice "d" is incorrect. Auditing standards differ from auditing procedures in that procedures relate to acts to be performed, whereas standards deal with the quality of the performance of those acts.

QUESTION 78

According to the profession's ethical standards, which of the following events may justify a departure from a Statement of Financial Accounting Standards?

	<i><u>New legislation</u></i>	<i><u>Evolution of a new form of business transaction</u></i>
A.	No	Yes
B.	Yes	No
C.	Yes	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Yes - Yes. Rule 203 of the code of professional conduct of the AICPA states that if the financial statements or data contain a GAAP departure, the departure may be justified if the CPA can demonstrate that due to unusual circumstances, such as new legislation or the evolution of a new form of business transaction, the FS would otherwise be misleading.

Under these circumstances, the auditor's report should describe the departure, its approximate effects, if practicable, and the reasons why compliance with the generally accepted principle would result in a misleading statement. Choices "a", "b", and "d" are incorrect, per the above explanation.

QUESTION 79

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. Cash flows from operating activities are negative.
- B. Research and development projects are postponed.
- C. Significant related party transactions are pervasive.
- D. Stock dividends replace annual cash dividends.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Negative cash flows from operating activities most likely would cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.

Choices "b" and "d" are incorrect. Plans to reduce or delay cash expenditures are mitigating factors conserving cash (e.g., postponing R&D projects and replacing cash dividends with stock dividends). This would not ordinarily cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.

Choice "c" is incorrect. The existence of significant related party transactions should be disclosed but would not ordinarily cause an auditor to have substantial doubt about an entity's ability to continue as a going concern.

QUESTION 80

For an entity that does not receive governmental financial assistance, an auditor's standard report on financial statements generally would not refer to:

- A. Significant estimates made by management.
- B. An assessment of the entity's accounting principles.
- C. Management's responsibility for the financial statements.
- D. The entity's internal control.



Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The auditor's standard report generally does not make reference to the entity's internal control. Note that for an entity that does receive governmental financial assistance, a written report on internal control is required.

Also, note that an auditor may (but is not required to) expand his or her audit report to clarify that a GAAS audit does not require the level of testing and reporting on internal control that is required for issuers. Choices "a" and "b" are incorrect. The scope paragraph states that, "an audit also includes assessing the accounting principles used and significant estimates made by management."

Choice "c" is incorrect. The introductory paragraph states that the "financial statements are the responsibility of the company's management."

QUESTION 81

Which of the following procedures should an auditor generally perform regarding subsequent events?

- A. Compare the latest available interim financial statements with the financial statements being audited.
- B. Send second requests to the client's customers who failed to respond to initial accounts receivable confirmation requests.
- C. Communicate material weaknesses in the internal control structure to those charged with governance.
- D. Review the cut-off bank statements for several months after the year-end.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. When performing procedures regarding subsequent events, the auditor generally will compare the latest available interim financial statements with the financial statements being audited to determine if any significant subsequent event occurred that would need to be reflected in the statements being audited.

Choice "b" is incorrect. Sending second requests to the client's customers who failed to respond to initial A/R confirmation requests is a substantive procedure that provides evidence about receivables existing at year end, not about subsequent events.

Choice "c" is incorrect. Internal control weaknesses should be communicated to those charged with governance, but this communication provides no evidence about subsequent events.

Choice "d" is incorrect. Bank cut-off statements generally are reviewed for only a week to ten days subsequent to year-end. Reviewing them for a longer period such as "several months" would provide little additional audit evidence regarding the YE FS and thus would not be a cost beneficial procedure.

QUESTION 82

An auditor's report contains the following sentences:

We did not audit the financial statements of JK Co., a wholly owned subsidiary, which statements reflect total assets and revenues constituting 17 percent and 19 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for JK Co., is based solely on the report of the other auditors. These sentences:

- A. Are an improper form of reporting.
- B. Divide responsibility.
- C. Disclaim an opinion.
- D. Qualify the opinion.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The report indicates a division of responsibility.

Choice "a" is incorrect. Words describing the percentages of revenues and assets audited by other auditors are proper in dividing responsibility.

Choice "c" is incorrect. Dividing responsibility does not affect the unqualified opinion, nor does it require a disclaimer of opinion. Choice

"d" is incorrect. Dividing responsibility does not affect the unqualified opinion, nor does it require a qualified opinion.

QUESTION 83

Which of the following phrases should be included in the opinion paragraph when an auditor expresses a qualified opinion?

	<i>When read in conjunction with <u>Note X</u></i>	<i>With the foregoing <u>explanation</u></i>
A.	Yes	No
B.	No	Yes
C.	Yes	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. No – No.

A qualified opinion phrase is, "in our opinion, except for [Explanation: of problem] as discussed in the preceding paragraph . . ."

Choice "a" is incorrect, as "when read in conjunction with Note X" is not a phrase included in the opinion paragraph of a qualified opinion.

Choice "b" is incorrect, as "with the foregoing Explanation: " is not a phrase included in the opinion paragraph of a qualified opinion.

Choice "c" is incorrect. Neither phrase is included in the opinion paragraph of a qualified opinion.

(This is why it's important to memorize the qualifying phrases as well as the standard independent auditor's report.)

QUESTION 84

Which of the following procedures would an auditor most likely perform to obtain evidence about the occurrence of subsequent events?

- A. Recomputing a sample of large-dollar transactions occurring after year-end for arithmetic accuracy.
- B. Investigating changes in stockholders' equity occurring after year-end.
- C. Inquiring of the entity's legal counsel concerning litigation, claims, and assessments arising after yearend.
- D. Confirming bank accounts established after year-end.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The auditor would most likely inquire of the entity's legal counsel concerning litigation, claims and assessments arising after year-end in order to obtain evidence about the occurrence of subsequent events. Claims arising after year-end might well impact the year-end financial statements.

Choice "a" is incorrect. Recomputing a sample of large-dollar transactions occurring after year-end for arithmetic accuracy would not provide evidence about year-end amounts.

Choice "b" is incorrect. The auditor would inquire about changes in stockholders' equity occurring after year-end, but would not generally perform an investigation of such items.

Choice "d" is incorrect. Confirming bank accounts established after year-end is generally not done (only those in existence at year-end are confirmed). Accounts established after year-end generally would not be relevant to year-end amounts.

QUESTION 85

What is an auditor's responsibility for supplementary information required by the GASB that is placed outside the basic financial statements?

- A. Label the information as unaudited and expand the auditor's report to include a disclaimer on the information.
- B. Add an explanatory paragraph to the auditor's report and refer to the information as "required supplementary information."
- C. Apply limited procedures to the information and report deficiencies in, or the omission of, the information.
- D. Audit the required supplementary information in accordance with generally accepted governmental auditing standards.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. With respect to supplementary information required by the GASB that is placed outside the basic financial statements, the auditor should apply limited procedures to the information (to determine that it is consistent with the basic audited financial statements) and report deficiencies in or the omission of the information (via an explanatory paragraph).

Choice "a" is incorrect. If the information is labeled "unaudited," a disclaimer generally would not be necessary.

Choice "b" is incorrect. The explanatory paragraph is only added if the supplemental information required by the GASB is deficient, omitted entirely, if the auditor cannot complete procedures, or if there is doubt about conformity with guidelines.

Choice "d" is incorrect. The supplementary information required by the GASB is not required to be audited since it is placed outside of the basic financial statements; however, an opinion is permitted.

QUESTION 86 An auditor's responsibility to express an opinion on the financial statements is:

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

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

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

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

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

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

QUESTION 87

When an independent CPA assists in preparing the financial statements of a publicly held entity, but has not audited or reviewed them, the CPA should issue a disclaimer of opinion. In such situations, the CPA has no responsibility to apply any procedures beyond:

- A. Ascertaining whether the financial statements are in conformity with generally accepted accounting principles.
- B. Determining whether management has elected to omit substantially all required disclosures.
- C. Documenting that the internal control structure is not being relied on.
- D. Reading the financial statements for obvious material misstatements.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When an independent CPA assists in preparing the FS of a publicly held entity, but has not "audited" or "reviewed" them, the CPA should issue a disclaimer of opinion and has only the responsibility to read the FS for obvious material misstatements.

Choice "a" is incorrect. A disclaimer does not require ascertaining whether the FS are in conformity with GAAP.

Choice "b" is incorrect. A disclaimer does not require ascertaining whether management has elected to omit substantially all required disclosures. Choice "c" is incorrect. A disclaimer of opinion does not require ascertaining whether or not the internal control structure is being relied upon.

QUESTION 88

An auditor issued an audit report that was dual dated for a subsequent event occurring after the original date of the auditor's report. The auditor's responsibility for events occurring subsequent to the original date was:

- A. Extended to subsequent events occurring through the date of reissuance of the report.
- B. Extended to include all events occurring since the original date of the auditor's report.
- C. Limited to the specific event referenced.
- D. Limited to include only events occurring up to the date of the last subsequent event referenced.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. When an auditor issues a report that is dual dated for a subsequent event occurring after the original date of the auditor's report, the auditor's responsibility for events occurring subsequent to the original date of the auditor's report is limited to the specific event referenced.

Choices "a", "b", and "d" are incorrect. The auditor takes responsibility for only the specific event noted in the dual dating and for no other event occurring subsequent to the original date of the auditor's report.

QUESTION 89 An auditor most likely would issue a disclaimer of opinion because of:

- A. Inadequate disclosure of material information.
- B. The omission of the statement of cash flows.
- C. A material departure from generally accepted accounting principles.
- D. Management's refusal to furnish written representations.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Management's refusal to furnish written representations is a significant client imposed restriction on the scope of an audit, ordinarily warranting a disclaimer of opinion.

Choice "a" is incorrect. Inadequate disclosure would result in a qualified or adverse opinion.

Choice "b" is incorrect. A qualified report would be appropriate when a "statement of cash flows" is omitted and the scope of the audit is not restricted. Choice

"c" is incorrect. A departure from GAAP would result in either a qualified or adverse opinion, depending on materiality.

QUESTION 90

When an auditor qualifies an opinion because of the inability to confirm accounts receivable by direct communication with debtors, the wording of the opinion paragraph of the auditor's report should indicate that the qualification pertains to the:

- A. Limitation on the auditor's scope.

- B. Possible effects on the financial statements.
- C. Lack of sufficient appropriate audit evidence.
- D. Departure from generally accepted auditing standards.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. When an auditor qualifies his or her opinion because of a scope limitation, such as the inability to confirm A/R, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the FS and not to the scope limitation itself.

The opinion paragraph should not refer to the scope limitation itself, the lack of evidence, or the departure from GAAS. Choices "a", "c", and "d" are incorrect, based on the above explanation.

QUESTION 91

The adverse effects of events causing an auditor to believe there is substantial doubt about an entity's ability to continue as a going concern would most likely be mitigated by evidence relating to the:

- A. Ability to expand operations into new product lines in the future.
- B. Feasibility of plans to purchase leased equipment at less than market value.
- C. Marketability of assets that management plans to sell.
- D. Committed arrangements to convert preferred stock to long-term debt.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The adverse effects of events causing an auditor to believe there is a substantial doubt about an entity's ability to continue as a going concern would most likely be mitigated by evidence relating to the marketability of assets that management plans to sell. By providing evidence that there is a ready market for assets that could be converted to cash, management has demonstrated that the company could remain in operation for a longer period of time, thereby mitigating the need for an explanatory paragraph describing the matter.

Choices "a", "b", and "d" are incorrect. Evidence regarding the ability to expand operations into new product lines in the future, the feasibility of plans to purchase leased equipment at less than market value, or committed arrangements to convert preferred stock to long-term debt would not be sufficient to mitigate doubts about an entity's ability to continue as a going concern, unless it could also be demonstrated that the events would provide adequate cash flow to fund operations for at least the next year.

QUESTION 92 An auditor was unable to obtain audited financial statements or other evidence supporting an entity's investment in a foreign subsidiary. Between which of the following opinions should the entity's auditor choose? A. Adverse and unqualified with an explanatory paragraph added.

- B. Disclaimer and unqualified with an explanatory paragraph added.
- C. Qualified and adverse.
- D. Qualified and disclaimer.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When an auditor is unable to obtain audited financial statements or other evidence supporting an entity's investment in a subsidiary (foreign or domestic), the auditor should issue a qualified or disclaimer of opinion depending on the materiality of the investment in the subsidiary.

Choices "a", "b", and "c" are incorrect. An adverse opinion is only issued when the FS are not presented fairly in conformity with GAAP, and an unqualified opinion with an explanatory paragraph is not appropriate for a scope limitation.

QUESTION 93 Which of the following standards requires a critical review of the work done and the judgment exercised by those assisting in an audit at every level of supervision?

- A. Proficiency.
- B. Audit risk.
- C. Inspection.
- D. Due care.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The third general standard is: "The auditor must exercise due professional care in the planning and performance of the audit and the preparation of the report." This standard is interpreted to require a critical review of the work performed and the judgment exercised at every level of supervision.

Choice "a" is incorrect. Proficiency relates to the first general standard (technical training and proficiency of an auditor).

Choice "b" is incorrect. Audit risk and materiality underlie the application of all the standards of fieldwork and reporting, but are not standards themselves. Choice

"c" is incorrect. Inspection pertains to the audit evidence standard, which is the third standard of fieldwork.

QUESTION 94 Six months after issuing an unqualified opinion on audited financial statements, an auditor discovered that the engagement personnel failed to confirm several of the client's material accounts receivable balances.

The auditor should first:

- A. Request the permission of the client to undertake the confirmation of accounts receivable.
- B. Perform alternative procedures to provide a satisfactory basis for the unqualified opinion.
- C. Assess the importance of the omitted procedures to the auditor's ability to support the previously expressed opinion.
- D. Inquire whether there are persons currently relying, or likely to rely, on the unqualified opinion.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. When an auditor discovers the omission of an audit procedure related to a previously issued report, the auditor should first assess the importance of the omitted procedure to the auditor's ability to support the previously expressed opinion.

Choice "a" is incorrect. The auditor would request the permission of the client to undertake the confirmation of accounts receivable only after determining that the procedure was necessary to support the previously expressed opinion and no other alternative procedure had been performed.

Choice "b" is incorrect. Alternative procedures would be performed only after the auditor determined that the procedure was necessary to support the previously expressed opinion. Choice

"d" is incorrect. The auditor needs to be able to support (or revise) the previously issued opinion regardless of whether or not there are persons currently relying on it.

QUESTION 95

Which of the following procedures would an auditor ordinarily perform during the review of subsequent events?

- A. Review the cut-off bank statements for the period after the year-end.
- B. Inquire of the client's legal counsel concerning litigation.
- C. Investigate significant deficiencies in internal control previously communicated to the client.
- D. Analyze related party transactions to discover possible irregularities.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. An auditor would most likely obtain a letter from the entity's legal counsel describing any pending litigation, unasserted claims, or loss contingencies, to obtain evidence that might impact the year-end financial statements.

Choice "a" is incorrect. Reviewing cut-off bank statements for the period after year-end generally is performed to evaluate the year-end cash balance, not to identify subsequent events.

Choice "c" is incorrect. Investigating significant deficiencies in internal control previously communicated to the client would be a procedure performed as part of the planning process and would provide the auditor with information regarding the internal control structure, not subsequent events.

Choice "d" is incorrect. Analyzing related party transactions to discover possible irregularities generally is performed to evaluate financial statement disclosure, not to identify subsequent events.

QUESTION 96

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.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. If the auditor performs sufficient procedures, he or she may report on whether the information is fairly stated, in all material respects, in relation to the financial statements.

Choices "a" and "b" are incorrect. The auditor may report on such information.

Choice "c" is incorrect. The report provides positive assurance about whether the information is fairly stated, in all material respects, in relation to the financial statements.

QUESTION 97 Tech Company has disclosed an uncertainty due to pending litigation. The auditor's decision to issue a qualified opinion rather than an unqualified opinion most likely would be determined by the:

- A. Lack of sufficient evidence.
- B. Inability to estimate the amount of loss.
- C. Entity's lack of experience with such litigation.
- D. Lack of insurance coverage for possible losses from such litigation.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Lack of sufficient evidence to support management's assertions would most likely cause an auditor to issue a qualified or disclaimer of opinion.

Choice "b" is incorrect. As long as it is fully disclosed, an inability to estimate the amount of loss from a future event (outcome of pending legislation) would most likely result in an unqualified opinion. Choices "c" and "d" are incorrect. Neither a lack of experience nor a lack of insurance coverage would impact the auditor's report.

QUESTION 98

It is not appropriate to refer a reader of an auditor's report to a financial statement footnote for details concerning:

- A. Subsequent events.
- B. The pro forma effects of a business combination.
- C. Sale of a discontinued operation.
- D. The results of confirmation of receivables.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Details concerning the results of audit procedures (such as the results of confirmation of receivables) generally do not appear in the footnotes.

Choice "a" is incorrect. Subsequent events may be discussed in an explanatory paragraph of the auditor's report, which would also refer to the related footnote.

Choice "b" is incorrect. The pro forma effects of a business combination may be included in an explanatory paragraph of the auditor's report, which would also refer to the related footnote. Choice

"c" is incorrect. Sale of a discontinued operation may be discussed in an explanatory paragraph of the auditor's report, which would also refer to the related footnote.

QUESTION 99

Morris, CPA, suspects that a pervasive scheme of illegal bribes exists throughout the operations of Worldwide Import-Export, Inc., a new audit client. Morris notified the audit committee and Worldwide's legal counsel, but neither could assist Morris in determining whether the amounts involved were material to the financial statements or whether senior management was involved in the scheme. Under these circumstances, Morris should:

- A. Express an unqualified opinion with a separate explanatory paragraph.
- B. Disclaim an opinion on the financial statements.
- C. Express an adverse opinion on the financial statements.
- D. Issue a special report regarding the illegal bribes.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Since the CPA could not determine whether the suspected illegal bribes were material to the financial statements, or whether senior management was involved in the scheme, Morris should disclaim an opinion on the financial statements.

Choice "a" is incorrect. An unqualified opinion with a separate explanatory paragraph is not appropriate if suspected material illegal bribes cannot be disproven.

Choice "c" is incorrect. An adverse opinion is inappropriate since the suspected material illegal bribes have not been proven, nor has any material effect on the financial statements been determined. Choice "d" is incorrect. Special reports are not issued regarding illegal bribes.

QUESTION 100

The first general standard requires that an audit of financial statements is to be performed by a person or persons having:

- A. Seasoned judgment in varying degrees of supervision and review.
- B. Adequate technical training and proficiency.
- C. Knowledge of the standards of fieldwork and reporting.
- D. Independence with respect to the financial statements and supplementary disclosures.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The "first" general standard states that the auditor must have adequate technical training and proficiency to perform the audit.

Comment: It is important to memorize the 10 auditing standards.

Choices "a", "c", and "d" are incorrect, as they do not represent a requirement of the first general standard of reporting.

QUESTION 101

An auditor's report that refers to the use of an accounting principle at variance with generally accepted accounting principles contains the words, "In our opinion, with the foregoing Explanation, the financial statements referred to above present fairly...." This is considered an:

- A. Adverse opinion.
- B. "Except for" qualified opinion.
- C. Unqualified opinion with an explanatory paragraph.
- D. Example of inappropriate reporting.



Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. "In our opinion, with the foregoing Explanation, the FS referred to above present fairly" is an example of inappropriate reporting. When an auditor's report refers to the use of an accounting principle at variance with GAAP, the words, "in our opinion, except for the effects of the matters discussed in the preceding paragraph, the FS referred to above present fairly,..." should be used.

Choice "a" is incorrect. An adverse opinion would include the phrase, "...do not present fairly..."

Choice "b" is incorrect. A qualified opinion would include the phrase, "In our opinion, except for the [problem] discussed in the preceding paragraph,..." Choice "c" is incorrect. An unqualified opinion would not include the phrase "with the foregoing Explanation: " in an explanatory paragraph.

QUESTION 102

Which of the following procedures is usually the first step in reviewing the financial statements of a nonissuer?

- A. Make preliminary judgments about risk and materiality to determine the scope and nature of the procedures to be performed.
- B. Obtain a general understanding of the entity's organization, its operating characteristics, and its products or services.
- C. Assess the risk of material misstatement arising from fraudulent financial reporting and the misappropriation of assets.
- D. Perform a preliminary assessment of the operating efficiency of the entity's internal control activities.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. In reviewing the financial statements of a nonpublic entity, one of the first steps would be to obtain sufficient knowledge of the entity's business, including its organization, operating characteristics, and products or services.

Choice "a" is incorrect. In an audit, preliminary judgments about risk and materiality are used to determine the scope and nature of procedures to be performed. A review is substantially less in scope than an audit and consists principally of inquiries and analytical procedures.

Choice "c" is incorrect. In an audit, the risk of material misstatement arising from fraud must be assessed in order to determine the scope and nature of procedures to be performed. A review is substantially less in scope than an audit and consists principally of inquiries and analytical procedures. While inquiries would be made about fraud, a formal fraud risk assessment is not required. Choice "d" is incorrect. In a review of a nonissuer's financial statements, no assessment or testing of internal control is required.

QUESTION 103

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.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. An accountant's standard report issued after compiling the financial statements of a nonissuer should state that "a compilation is limited to presenting in the form of financial statements information that is the representation of management."

Choice "a" is incorrect. A review report (and not a compilation report) states that, "I am not aware of any material modifications that should be made to the accompanying financial statements."

Choice "b" is incorrect. A review report (and not a compilation report) states that a review "consists principally of inquiries of company personnel and analytical procedures."

Choice "d" is incorrect. A review report (and not a compilation report) states that a review "is substantially less in scope than an audit in accordance with GAAS, the objective of which is the expression of an opinion."

QUESTION 104

Which of the following would be used on a review engagement?

- A. Examination of board minutes.
- B. Confirmation of cash and accounts receivable.
- C. Comparison of current-year to prior-year account balances.
- D. Recalculation of depreciation expense.



Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A review consists of inquiries and analytical procedures. Comparison of current year and prior year account balances is an analytical procedure that would often be performed as part of a review. Choice "a" is incorrect. Examining board minutes is an audit procedure that would not typically be performed in a review.

Choice "b" is incorrect. Confirmations of cash and accounts receivable are audit procedures that would not typically be performed in a review. Choice

"d" is incorrect. Recalculation of expenses is an audit procedure that would not typically be performed in a review.

QUESTION 105

Which of the following statements is true regarding an accountant's consideration of fraud/illegal acts in compilation and review engagements?

- A. The accountant is not required to perform procedures designed to detect material misstatements due to fraud or illegal acts.
- B. The accountant must inform an appropriate level of management of all instances of fraud or illegal acts.
- C. The accountant must report only definite instances of fraud or an illegal act, but need not report information indicating that fraud or an illegal act may have occurred.
- D. Information indicating that fraud or an illegal act may have occurred should be reported in writing to an appropriate level of management.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The accountant is not required to specifically assess fraud risk or to perform procedures designed to detect material misstatements due to fraud or illegal acts.

Choice "b" is incorrect. Inconsequential instance of fraud or illegal acts need not be reported to management.

Choice "c" is incorrect. The accountant should report to an appropriate level of management any evidence or information that comes to his or her attention indicating that fraud or an illegal act may have occurred.

Choice "d" is incorrect. Information indicating that fraud or an illegal act may have occurred should be reported to an appropriate level of management, but it need not be in writing. Oral communication to management should be documented.

QUESTION 106

An accountant had begun to audit the financial statements of a nonissuer. Which of the following circumstances most likely would be considered a reasonable basis for agreeing to the entity's request to change the engagement to a compilation?

- A. The entity's management does not provide the accountant with a signed representation letter.
- B. The accountant is prohibited from corresponding with the entity's legal counsel.
- C. The entity's principal creditors no longer require the entity to furnish audited financial statements.
- D. The accountant is prevented from examining the minutes of the board of directors' meetings.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. An audit may be changed to a compilation or review due to a change in client requirements. Since the creditors no longer require audited financial statements, this is a valid reason for requesting a change. Choices "a", "b", and "d" are incorrect. Client-imposed scope limitations, such as refusing to provide a signed representation letter, prohibiting correspondence with legal counsel, or refusing to allow examination of board minutes, are indicative of a lack of cooperation by management. Such limitations would not be a valid basis for changing an engagement from an audit to a compilation.

QUESTION 107

Which of the following statements is correct regarding a review engagement of a nonissuer's financial statements performed in accordance with the Statements on Standards for Accounting and Review Services (SSARS)? A.

An accountant must establish an understanding with the client in an engagement letter.

- B. An accountant must obtain an understanding of the client's internal control when performing a review.
- C. A review provides an accountant with a basis for expressing limited assurance on the financial statements.
- D. A review report contains an accountant's opinion of the financial statements taken as a whole.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A review report is issued when inquiry and analytical procedures provide a reasonable basis for the expression of limited assurance on the financial statements.

Choice "a" is incorrect. While the accountant is required to establish an understanding with the client, preferably in writing, an engagement letter is not required.

Choice "b" is incorrect. When performing a review under SSARS, the accountant is not required to obtain an understanding of the client's internal control.

Choice "d" is incorrect. A review results in the expression of limited assurance that no material modifications are necessary for the financial statements to be in conformity with generally accepted accounting principles. The limited nature of the work performed during a review does not provide sufficient evidence for an opinion on the financial statements taken as a whole.

QUESTION 108

Which of the following procedures does a CPA normally perform first in a review engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS)?

- A. Inquiry regarding the client's principles and practices and the method of applying them.
- B. Inquiry concerning the effectiveness of the client's system of internal control.
- C. Inquiry to identify transactions between related parties and management.
- D. Inquiry of the client's professional advisors, including bankers, insurance agents, and consultants.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. In performing a review engagement in accordance with SSARS, the accountant should inquire of management regarding the accounting principles and practices used, and the method of applying them.

Choice "b" is incorrect. When performing a review under SSARS, the accountant is not required to make inquiries concerning the client's system of internal control.

Choice "c" is incorrect. The accountant may inquire about the existence of related party transactions, but would likely make a more basic inquiry, about the client's accounting principles and practices, first. Choice "d" is incorrect. In performing a review engagement in accordance with SSARS, the accountant generally directs his/her inquiries to members of management, not to external parties.

QUESTION 109

Which of the following describes how the objective of a review of financial statements differs from the objective of a compilation engagement?

- A. The primary objective of a review engagement is to test the completeness of the financial statements prepared, but a compilation tests for reasonableness.
- B. The primary objective of a review engagement is to provide positive assurance that the financial statements are fairly presented, but a compilation provides no such assurance.
- C. In a review engagement, accountants provide limited assurance, but a compilation expresses no assurance.
- D. In a review engagement, accountants provide reasonable or positive assurance that the financial statements are fairly presented, but a compilation provides limited assurance.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A review provides limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles, whereas a compilation provides no assurance.

Choice "a" is incorrect. A review does not test for completeness, nor does a compilation test for reasonableness. A review provides limited assurance about the financial statements based on inquiry and analytical review procedures, while a compilation provides no assurance and includes no testing for reasonableness.

Choice "b" is incorrect. A review provides limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles, and it is based on inquiry and analytical review procedures. Positive assurance (such as an audit opinion) is only provided when more extensive procedures have been performed.

Choice "d" is incorrect. A review provides limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles, and it is based on inquiry and analytical review procedures. Positive or reasonable assurance (such as an audit opinion) is only provided when more extensive procedures have been performed. A compilation provides no assurance at all.

QUESTION 110

The standard report issued by an accountant after reviewing the financial statements of a nonissuer should state that:

- A. A review is limited to presenting in the form of financial statements information that is the representation of management.
- B. A review consists of inquiries of company personnel and analytical procedures applied to financial data.
- C. The accountant does not express an opinion or any other form of assurance on the financial statements.
- D. The accountant did not obtain an understanding of the entity's internal control or assess control risk.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The standard report issued by an accountant after reviewing the financial statements of a nonissuer states that a review consists of inquiries of company personnel and analytical procedures applied to financial data.

Choice "a" is incorrect. A compilation report uses language similar to this, stating that a compilation is limited to presenting, in the form of financial statements, information that is the representation of management.

Choice "c" is incorrect. A compilation report uses language similar to this, stating that the accountant does not express an opinion or any other form of assurance on the financial statements. A review provides negative assurance.

Choice "d" is incorrect. While it is true that a review of the financial statements of a nonpublic entity does not require the accountant to obtain an understanding of the entity's internal control or assess control risk, the report does not explicitly state this.

QUESTION 111

While auditing the financial statements of a nonissuer, a CPA was requested to change the engagement to a review in accordance with Statements on Standards for Accounting and Review Services (SSARS) because of a scope limitation.

If the CPA believes the client's request is reasonable, the CPA's review report should:

- I. Refer to the scope limitation that caused the change.
 - II. Describe the auditing procedures that have already been applied.
- A. I only.
 - B. II only.
 - C. Both I and II.
 - D. Neither I nor II.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. If the CPA believes the client's request is reasonable, he/she must comply with the standards for a review and issue an appropriate report. The report should not refer to the original engagement, to any auditing procedures performed, or to the scope limitation.
 Choices "a", "b", and "c" are incorrect, based on the above Explanation: .
 Reporting on Comparative Financial Statements

QUESTION 112 When unaudited financial statements of a nonissuer are presented in comparative form with audited financial statements in the subsequent year, the unaudited financial statements should be clearly marked to indicate their status and:

- I. The report on the unaudited financial statements should be reissued.
 - II. The report on the audited financial statements should include a separate paragraph describing the responsibility assumed for the unaudited financial statements.
- A. I only.
 - B. II only.
 - C. Both I and II.
 - D. Either I or II.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When audited financial statements are presented in comparative form with unaudited financial statements from a prior year, the auditor should either reissue his or her report on the unaudited statements or include a separate paragraph in the current year report describing the responsibility assumed for the unaudited statements. Choices "a", "b", and "c" are incorrect, per above explanation.

QUESTION 113

When unaudited financial statements are presented in comparative form with audited financial statements in a document filed with the Securities and Exchange Commission, such statements should be:

	<i>Marked as "unaudited"</i>	<i>Withheld until audited</i>	<i>Referred to in the auditors report</i>
A.	Yes	No	No
B.	Yes	No	Yes
C.	No	Yes	Yes
D.	No	Yes	No



- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. When unaudited financial statements (generally the first quarter of the following year in an annual report) are presented in comparative form with audited financial statements in documents filed with the SEC, such statements should be clearly marked as "unaudited," but should not be referred to in the auditor's report. The statements need not be withheld until audited. Choices "b", "c", and "d" are incorrect, based on explanation above.

QUESTION 114

Clark, CPA, compiled and properly reported on the financial statements of Green Co., a nonissuer, for the year ended March 31, 20X1. These financial statements omitted substantially all disclosures required by generally accepted accounting principles (GAAP). Green asked Clark to compile the statements for the year ended March 31, 20X2, and to include all GAAP disclosures for the 20X2 statements only, but otherwise present both years' financial statements in comparative form. What is Clark's responsibility concerning the proposed engagement?

- A. Clark may not report on the comparative financial statements because the 20X1 statements are not comparable to the 20X2 statements that include the GAAP disclosures.
- B. Clark may report on the comparative financial statements provided the 20X1 statements do not contain any obvious material misstatements.
- C. Clark may report on the comparative financial statements provided an explanatory paragraph is added to Clark's report on the comparative financial statements.
- D. Clark may report on the comparative financial statements provided Clark updates the report on the 20X1 statements that do not include the GAAP disclosures.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Compiled financial statements that omit substantially all the disclosures required by GAAP are not comparable to financial statements that do include required GAAP disclosures.

Accordingly, the 20X1 statements are not comparable to the 20X2 statements and Clark cannot report on them.

Choice "b" is incorrect. The lack of material misstatements does not alter the fact that the statements are not comparable and therefore Clark may not report on them.

Choice "c" is incorrect. Compiled financial statements that omit substantially all of the disclosures required by GAAP are not comparable to financial statements that include such disclosures. Accordingly, Clark may not report on the comparative financial statements, even if an explanatory paragraph is added.

Choice "d" is incorrect. Updating the auditor's report does not change the fact that the financial statements for the two periods are not comparable.

QUESTION 115

Silver, CPA, has been hired by Andrews Co., a publicly held company, to conduct a review of its interim financial information. While performing review procedures, Silver becomes aware of a significant change in the control activities at one of Andrew's branch locations. Which of the following might Silver consider performing in response to this situation?

- A. Making additional inquiries, such as whether management has monitored the changes and considered whether they were operating as intended.
- B. Employing analytical procedures with a less precise expectation.
- C. Both "a" and "b" above.
- D. Neither "a" nor "b" above.

Correct Answer: A

Section: Auditing and Attestation Explanation



Explanation/Reference:

Explanation:

Choice "a" is correct. An accountant's knowledge of an entity's business and its internal control influences the inquiries made and analytical procedures performed. A significant change in control activities would likely result in further inquiry of management.

Choice "b" is incorrect. An accountant's knowledge of an entity's business and its internal control influences the inquiries made and analytical procedures performed. A significant change in control activities would likely result in the accountant employing analytical procedures with a more precise expectation, since more precise expectations are more effective at detecting misstatements. Choices "c" and "d" are incorrect. Only choice "a" is correct, as explained above.

QUESTION 116

Davidson, CPA, is performing a review under auditing standards of Gold's interim financial information.

As part of planning, Davidson reads the audit documentation from the preceding year's annual audit. Which of the following is least likely to affect Davidson's review?

- A. A summary of both corrected and uncorrected misstatements.
- B. Identified risks of material misstatement due to fraud.
- C. Significant weaknesses in internal control.
- D. Scope limitations that were overcome through acceptable alternative procedures.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Scope limitations relate to problems in performing the audit, and, especially since they were overcome, they would bear little relationship to procedures performed in a review.

Choice "a" is incorrect. The nature of corrected misstatements should be considered, as they may be indicative of an ongoing problem. Uncorrected misstatements must also be considered as misstatements in one period often affect subsequent periods.

Choice "b" is incorrect. Identified risks of material misstatement due to fraud help the accountant to identify the types of material misstatements that may occur in the interim financial information, and to consider the likelihood of their occurrence.

Choice "c" is incorrect. Consideration of significant weaknesses in internal control helps the accountant identify the types of material misstatements that may occur in the interim financial information, and to consider the likelihood of their occurrence.

QUESTION 117 The annual financial statements of a publicly held company have been audited, and its interim financial statements have been reviewed. Which of the following is true about the application of professional standards to this review?

- A. PCAOB standards apply.
- B. Statements on Standards for Accounting and Review Services apply.
- C. Both PCAOB standards and SSARS apply.
- D. None of the above.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A review of the interim financial information of a publicly held company is conducted in accordance with PCAOB standards, and it is these standards which should be referenced in the auditor's review report. (Note, however, that the PCAOB has adopted, at least initially, generally accepted auditing standards in this area.)

Choices "b" and "c" are incorrect. Statements on Standards for Accounting and Review Services apply to reviews of the financial statements of nonissuers. Choice "d" is incorrect. A review of the interim financial information of a publicly held company is conducted in accordance with PCAOB standards.

QUESTION 118

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.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A review of interim financial information is not designed to provide information regarding an entity's ability to continue as a going concern. Even if such information comes to the accountant's attention, the accountant is not required to corroborate it.

Choice "b" is incorrect. As part of a review, the accountant is required to compare disaggregated revenue data for the current interim period with that of comparable prior periods.

Choice "c" is incorrect. As part of a review, the accountant is required to obtain evidence that the interim financial information reconciles with the accounting records.

Choice "d" is incorrect. As part of a review, the accountant is required to inquire of management about their knowledge of fraud, suspected fraud, or allegations of fraud.

QUESTION 119

In which case would the accountant be least likely to perform a review of interim financial information under PCAOB (auditing) standards?

- A. Quarterly reports are required to be filed with the SEC.
- B. Selected quarterly financial data is included in an annual report.
- C. Quarterly financial data is included in the financial statements of a nonissuer.
- D. The accountant is performing an initial audit of financial statements that include selected quarterly data.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A review of data included in financial statements of a nonissuer is performed under Statements on Standards for Accounting and Review Services, not under PCAOB (auditing) standards. A review of interim financial information under PCAOB (auditing) standards is only conducted for public companies (or companies anticipating going public).

Choice "a" is incorrect. When an entity is required by the SEC to file a quarterly report, the SEC also requires that an independent accountant perform a review (of the interim financial information) in accordance with PCAOB (auditing) standards before the report is filed.

Choice "b" is incorrect. When a company is required by the SEC to include selected quarterly financial data in its annual report or in other SEC filings, a review (of the interim financial information) in accordance with PCAOB (auditing) standards is required.

Choice "d" is incorrect. An accountant performing an initial audit of financial statements that include selected quarterly data should also perform a review (of the interim financial information) in accordance with PCAOB (auditing) standards as part of the overall audit.

QUESTION 120

An independent accountant's report is based on a review of interim financial information. If this report is presented in a registration statement, a prospectus should include a statement clarifying that the:

- A. Accountant's review report is not a part of the registration statement within the meaning of the Securities Act of 1933.
- B. Accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.
- C. Accountant's review was performed in accordance with standards established by the Securities and Exchange Commission.
- D. Accountant obtained corroborating evidence to determine whether material modifications are needed for such information to conform with GAAP.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. If a report on a review of interim financial information is presented in a registration statement, the prospectus should include a statement that the report is not a "report" or "part" of the registration statement. The accountant should also read the other portions of the registration statement to ensure that his or her name is not used in a way that indicates greater responsibility than s/he intends.

Choice "b" is incorrect. The auditor is responsible to update the report for events occurring after the date of the report but prior to filing.

Choice "c" is incorrect. The accountant's review of interim financial information is performed in accordance with PCAOB standards, as approved (not established) by the SEC. Choice "d" is incorrect. Obtaining corroborating evidence is an audit procedure, not a review procedure.

QUESTION 121

The objective of a review of interim financial information of a public entity is to provide an accountant with a basis for reporting whether:

- A. A reasonable basis exists for expressing an updated opinion regarding the financial statements that were previously audited.
- B. Material modifications should be made to conform with generally accepted accounting principles.
- C. The financial statements are presented fairly in accordance with standards of interim reporting.
- D. The financial statements are presented fairly in accordance with generally accepted accounting principles.

Correct Answer: B

Section: Auditing and Attestation Explanation

**Explanation/Reference:**

Explanation:

Choice "b" is correct. The objective of a review is to provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the accompanying financial statements for them to be in conformity with generally accepted accounting principles.

Choice "a" is incorrect. When performing a review, the accountant does not gather enough evidence to update an audit opinion.

Choice "c" is incorrect. There are no "standards of interim reporting."

Choice "d" is incorrect. Expressing an opinion as to whether the financial statements are presented fairly in accordance with GAAP is the result of an audit, not a review.

QUESTION 122

The quarterly data required by SEC Regulation S-K have been omitted. Which of the following statements must be included in the auditor's report?

- A. The auditor was unable to review the data.
- B. The company's internal control provides an adequate basis to complete the review.
- C. The company has not presented the selected quarterly financial data.
- D. The auditor will review the selected data during the review of the subsequent quarterly financial data.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. If the quarterly data required by SEC Regulation S-K have been omitted, the auditor's report must include a statement indicating that the company has not presented such data.

Choice "a" is incorrect. The auditor's report should only state that the auditor was unable to review quarterly data required by SEC Regulation S-K when the data have been included, but the auditor has not reviewed such data.

Choice "b" is incorrect. Generally, the auditor's report does not make reference to a review of interim financial information, since such information is not a required part of GAAP financial statements. (Note, however, that the auditor's report might be modified to indicate that the company's internal control was not sufficient to provide an adequate basis for a review of such information, in situations where quarterly data is included but not reviewed).

Choice "d" is incorrect. If an entity is required to file quarterly reports, a review of this quarterly data is also required. Such review should be completed before the quarterly report is filed, not postponed to a subsequent quarter.

QUESTION 123 Which of the following matters is covered in a typical comfort letter?

- A. Negative assurance concerning whether the entity's internal controls operated as designed during the period being audited.
- B. An opinion regarding whether the entity complied with laws and regulations under Government Auditing Standards and the Single Audit Act of 1984.
- C. Positive assurance concerning whether unaudited condensed financial information complied with generally accepted accounting principles.
- D. An opinion as to whether the audited financial statements comply in form with the accounting requirements of the SEC.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. In a typical comfort letter, the accountants express an opinion (i.e., positive assurance) concerning the financial statements' compliance (as to form) with the pertinent accounting requirements of the SEC. Choice

"a" is incorrect. No assurance is generally provided in a comfort letter regarding the operation of an entity's internal control.

Choice "b" is incorrect. A typical comfort letter is addressed to the underwriters of the securities.

Government Auditing Standards and the Single Audit Act are not applicable to a comfort letter related to the issuance of securities.

Choice "c" is incorrect. Negative assurance (not positive) is typically provided regarding unaudited condensed financial information.

QUESTION 124 Comfort letters ordinarily are signed by the client's:

- A. Independent auditor.
- B. Underwriter of securities.
- C. Audit committee.
- D. Senior management.

Correct Answer: A

Section: Auditing and Attestation Explanation



Explanation/Reference:

Explanation:

Choice "a" is correct. A comfort letter is a letter containing a negative assurance from the CPA to the underwriter or certain other requesting parties just before the registration of the client's securities. Choice

"b" is incorrect. The comfort letter is sent to the underwriter.

Choice "c" is incorrect. The audit committee does not sign a comfort letter.

Choice "d" is incorrect. Senior management may sign a client representation letter, not a comfort letter.

QUESTION 125

When an accountant issues to an underwriter a comfort letter containing comments on data that have not been audited, the underwriter most likely will receive:

- A. Negative assurance on capsule information.
- B. Positive assurance on supplementary disclosures.
- C. A limited opinion on "pro forma" financial statements.
- D. A disclaimer on prospective financial statements.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. When an accountant issues to an underwriter a comfort letter containing comments on data that have not been audited, the underwriter most likely will receive negative assurance on capsule information.

Choice "b" is incorrect. Positive assurance cannot be given if the information was not audited.

Choices "c" and "d" are incorrect. A comfort letter generally covers the period from the date of the last auditor's report to the effective date of the registration. It does not cover "pro forma" or prospective financial statements.

QUESTION 126

Comfort letters ordinarily are:

	<u>Addressed to the client's</u>	<u>Signed by the client's</u>
A	Audit committee	Independent auditor
B	Underwriter of securities	Senior management
C	Audit committee	Senior management
D	Underwriter of securities	Independent auditor

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A comfort letter is a letter from the independent auditor to the named underwriter just before the registration of the client's securities. Choices "a", "b", and "c" are incorrect, based on the above explanation.

QUESTION 127

A CPA in public practice is required to comply with the provisions of the Statements on Standards for Attestation Engagements (SSAE) when:

	<u>Testifying as an expert witness in accounting and auditing matters given stipulated facts</u>	<u>Compiling a client's financial projection that presents a hypothetical course of action</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Statements on Standards for Attestation Engagements provide guidance with respect to compilation of a financial projection, but they do not address services involving advocating for a client, such as testifying as an expert witness.

Choices "a", "b", and "d" are incorrect, per above explanation.

QUESTION 128

In an attest engagement, use of the accountant's report should be restricted to specified parties in all of the following situations, except:

- A. When the criteria used to evaluate the subject matter are appropriate for only a limited number of parties.
- B. When reporting on an assertion about the subject matter instead of reporting directly on the subject matter.
- C. When reporting directly on the subject matter and a written assertion has not been provided.
- D. When reporting on an agreed-upon procedures engagement.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. There is no requirement that the accountant's report be restricted to specified parties when reporting on an assertion about the subject matter instead of reporting directly on the subject matter.

Choice "a" is incorrect, since use of the accountant's report should be restricted to specified parties when the criteria used to evaluate the subject matter are appropriate for only a limited number of parties. Choice

"c" is incorrect, since use of the accountant's report should be restricted to specified parties when reporting directly on the subject matter and a written assertion has not been provided.

Choice "d" is incorrect, since use of the accountant's report should be restricted to specified parties when reporting on an agreed-upon procedures engagement.

QUESTION 129

Which of the following is a term for an attest engagement in which a CPA assesses a client's commercial Internet site for predefined criteria that are designed to measure transaction integrity, information protection, and disclosure of business practices?

- A. ElectroNet.
- B. EDIFACT.C. TechSafe.
- D. WebTrust.

Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A WebTrust engagement is an attestation engagement designed to measure transaction integrity, information protection, and disclosure of business practices. When an unqualified report is issued, the client may add the CPA WebTrust Seal to its Web site, indicating that its site is a reasonably safe and private place for e-commerce. Choice "a" is incorrect. ElectroNet is an Internet service provider.

Choice "b" is incorrect. EDIFACT refers to standards developed by the United Nations for Electronic Data Interchange for Administration, Commerce, and Transport. These standards facilitate information flow among trading partners in many industries. The scope and format of these standards is similar, but not identical, to those developed in the United States. Choice "c" is incorrect. TechSafe is a distracter.

QUESTION 130

An entity engaged a CPA to determine whether the client's web sites meet defined criteria for standard business practices and controls over transaction integrity and information protection. In performing this engagement, the CPA should comply with the provisions of:

- A. Statements on Assurance Standards.
- B. Statements on Standards for Attestation Engagements.
- C. Statements on Standards for Management Consulting Services.
- D. Statements on Auditing Standards.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A WebTrust engagement is an attestation engagement in which the CPA determines whether the client's web site meets defined criteria relating to transaction integrity, information protection, and disclosure of business practices. Attestation engagements should be performed in accordance with Statements on Standards for Attestation Engagements (SSAEs). Choice "a" is incorrect. Statements on Assurance Standards is a distracter.

Choice "c" is incorrect. Consulting services provided by CPAs range from advice on accounting-related matters to a wide range of services involving diverse technical disciplines. Consulting services performed by CPAs should be performed in accordance with Statements on Standards for Consulting Services (SSCSs).

Choice "d" is incorrect. Audits (generally of financial statements) performed by CPAs should be performed in accordance with Statements on Auditing Standards (SASs).

QUESTION 131

A CPA's report on agreed-upon procedures related to management's assertion about an entity's compliance with specified requirements should contain:

- A. A statement of limitations on the use of the report.
- B. An opinion about whether management's assertion is fairly stated.
- C. Negative assurance that control risk has not been assessed.
- D. An acknowledgment of responsibility for the sufficiency of the procedures.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The practitioner's report on agreed-upon procedures related to management's assertion about the entity's compliance with specified requirements is intended solely for the use of specified parties. Thus, the report should include a statement of limitations on the use of the report.

Choice "b" is incorrect. The report is in the form of procedures and findings. Since the work performed is less in scope than an examination, the accountant disclaims any opinion.

Choice "c" is incorrect. The auditor does not provide any negative assurance relative to assessment of control risk or to compliance with the specified requirements.

Choice "d" is incorrect. The report contains a statement that the sufficiency of the procedures is solely the responsibility of the parties specifying the procedures and a disclaimer of responsibility on the part of the accountant.

QUESTION 132

When an accountant examines projected financial statements, the accountant's report should include a separate paragraph that:

- A. Describes the limitations on the usefulness of the presentation.
- B. Provides an Explanation: of the differences between an examination and an audit.
- C. States that the accountant is responsible for events and circumstances up to one year after the report's date.
- D. Disclaims an opinion on whether the assumptions provide a reasonable basis for the projection.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The accountant's standard report on an examination of projected financial statements should include a caveat that the projected results may not be achieved. This is included in a separate paragraph that describes the limitations on the usefulness of the presentation: "...there will usually be differences between the forecasted and actual results... [that] may be material."

Choice "b" is incorrect. The accountant's report on the examination of projected financial statements would not include an Explanation: of the differences between an examination and an audit.

Choice "c" is incorrect. A statement is included which specifically states that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

Choice "d" is incorrect. The accountant does express an opinion that "the underlying assumptions provide a reasonable basis for management's forecast."

QUESTION 133 An examination of a financial forecast is a professional service that involves:

- A. Compiling or assembling a financial forecast that is based on management's assumptions.
- B. Limiting the distribution of the accountant's report to management and the board of directors.
- C. Assuming responsibility to update management on key events for one year after the report's date.
- D. Evaluating the preparation of a financial forecast and the support underlying management's assumptions.



Correct Answer: D

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. An examination of a financial forecast is a professional service that involves:

- 1) evaluating the preparation of the prospective financial statements,
- 2) evaluating the support underlying the assumptions,
- 3) evaluating the presentation of the prospective financial statements in conformity with AICPA guidelines, and
- 4) issuing an examination report.

Choice "a" is incorrect. Compiling or assembling a financial forecast based on management's assumptions is part of a compilation engagement, not an examination engagement.

Choice "b" is incorrect. A financial forecast may be issued for general use.

Choice "c" is incorrect. The accountant's standard report specifically states that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

QUESTION 134

An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that:

- A. Use of the report is restricted to the specified parties.
- B. The prospective financial statements are also examined.
- C. Responsibility for the adequacy of the procedures performed is taken by the accountant.
- D. Negative assurance is expressed on the prospective financial statements taken as a whole.

Correct Answer: A

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that certain conditions are met, including that the use of the report be restricted to the specified parties.

Choice "b" is incorrect. There is no requirement that the prospective financial statements be examined.

In fact, the practitioner's report on the application of agreed-upon procedures states that the auditor did not perform an examination.

Choice "c" is incorrect. The specified parties must understand that they take responsibility for the sufficiency of the attest procedures. Choice

"d" is incorrect. No assurance is expressed in an agreed-upon procedures engagement.

QUESTION 135 An accountant's compilation report on a financial forecast should include a statement that:

- A. The forecast should be read only in conjunction with the audited historical financial statements.
- B. The accountant expresses only limited assurance on the forecasted statements and their assumptions.
- C. There will usually be differences between the forecasted and actual results.
- D. The hypothetical assumptions used in the forecast are reasonable in the circumstances.

Correct Answer: C

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. The accountant's compilation report on a client's financial forecast should include a caveat that the prospective results may not be achieved.

Choice "a" is incorrect. The historical financial statements upon which the forecast is based need not be audited, nor must they accompany the forecast compilation.

Choice "b" is incorrect. The accountant expresses no assurance in the compilation report on forecasted statements.

Choice "d" is incorrect. A compilation of a financial forecast would not include evaluation of the support for the assumptions underlying the forecast.

QUESTION 136

Which of the following is a conceptual difference between the attestation standards and generally accepted auditing standards?

- A. The attestation standards provide a framework for the attest function beyond historical financial statements.
- B. The requirement that the practitioner be independent in mental attitude is omitted from the attestation standards.
- C. The attestation standards do not permit an attest engagement to be part of a business acquisition study or a feasibility study.
- D. None of the standards of fieldwork in generally accepted auditing standards are included in the attestation standards.

Correct Answer: A

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. Attestation standards provide a framework for the attest function beyond historical financial statements.

Choice "b" is incorrect. The independence standard is almost the same for both attest engagements and audits.

Choice "c" is incorrect. An attest engagement may be part of a larger engagement (such as a business acquisition study or a feasibility study).

Choice "d" is incorrect. Attestation standards include two of the three GAAS fieldwork standards: planning/supervision and evidence. They do not include the internal control standard.

QUESTION 137 An accountant's report on a review of pro forma financial information should include a:

- A. Statement that the entity's internal control was not relied on in the review.
- B. Disclaimer of opinion on the financial statements from which the pro forma financial information is derived.
- C. Caveat that it is uncertain whether the transaction or event reflected in the pro forma financial information will ever occur.
- D. Reference to the financial statements from which the historical financial information is derived.

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

Correct Answer: D

Choice "d" is correct. The accountant's report on a review of pro forma financial information should include a reference to the financial statements from which the historical information is derived and a statement as to whether such financial statements were audited or reviewed.

Choice "a" is incorrect. No statement on the entity's internal control is necessary.

Choice "b" is incorrect. If the auditor has audited the financial statements from which the pro forma financial information is derived, an opinion on those statements may be expressed.

Choice "c" is incorrect. The report on a review of pro forma financial information would include an Explanation: of the objective and limitations of the information, but would not discuss the uncertainty surrounding occurrence of the transaction or event.

QUESTION 138 In performing an attest engagement,
a CPA typically:

- A. Supplies litigation support services.
- B. Assesses control risk at a low level.
- C. Issues a report on subject matter (or on an assertion about subject matter) that is the responsibility of another party.
- D. Provides management consulting advice.

Correct Answer: C**Section: Auditing and Attestation****Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. In performing an attest engagement, a CPA typically issues a report on subject matter (or on an assertion about subject matter) that is the responsibility of another party.

Choice "a" is incorrect. Supplying litigation support services is not an attest engagement because the CPA is not reporting on subject matter (or an assertion about subject matter) that is the responsibility of another party.

Choice "b" is incorrect. An attest engagement may include a report on internal control; however, the assessed level of control risk may or may not be at a low level.

Choice "d" is incorrect. Management consulting advice is not considered to be an attest engagement because the CPA is not reporting on subject matter (or on an assertion about subject matter) that is the responsibility of another party.

QUESTION 139 An accountant's standard report on a compilation of a projection
should not include a:

- A. Statement that a compilation of a projection is limited in scope.
- B. Disclaimer of responsibility to update the report for events occurring after the report's date.
- C. Statement that the accountant expresses only limited assurance that the results may be achieved.
- D. Separate paragraph that describes the limitations on the presentation's usefulness.

Correct Answer: C**Section: Auditing and Attestation****Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. A compilation of prospective financial statements is not intended to provide assurance on the prospective financial statements or the assumptions underlying such statements.

Choice "a" is incorrect. The report on a compilation should include a statement that a compilation is limited in scope.

Choice "b" is incorrect. The report on a compilation should include a statement that the accountant assumes no responsibility to update the report for events subsequent to the report date. Choice

"d" is incorrect. The report on a compilation should include a separate paragraph that describes the limitations on the presentation's usefulness.

QUESTION 140 Which of the following is not an
attestation standard?

- A. Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.
- B. The report shall identify the assertion being reported on and state the character of the engagement.
- C. The work shall be adequately planned and assistants, if any, shall be properly supervised.

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

D. A sufficient understanding of internal control shall be obtained to plan the engagement.

Correct Answer: D

Choice "d" is correct. A sufficient understanding of internal control is not required to be obtained in an attestation engagement.

Choice "a" is incorrect. In an attestation engagement, sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.

Choice "b" is incorrect. An attestation report should identify the assertion being reported on and state the character of the engagement.

Choice "c" is incorrect. In an attestation engagement, the work should be adequately planned and assistants, if any, should be properly supervised.

QUESTION 141 An accountant's compilation report on a financial forecast should include a statement that the:

- A. Compilation does not include evaluation of the support of the assumptions underlying the forecast.
- B. Hypothetical assumptions used in the forecast are reasonable.
- C. Range of assumptions selected is one in which one end of the range is less likely to occur than the other.
- D. Prospective statements are limited to presenting, in the form of a forecast, information that is the accountant's representation.

Correct Answer: A**Section: Auditing and Attestation****Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. An accountant's compilation report on a financial forecast should include a statement that the compilation does not include evaluation of the support of the assumptions underlying the forecast. (An examination of the financial forecast would include evaluation of the support).

Choice "b" is incorrect. An accountant does not give any form of assurance related to hypothetical assumptions, which are not used in financial forecasts anyway. (Hypothetical assumptions are used in financial projections). Choice "c" is incorrect. No mention of the range of assumptions selected is made in the compilation report.

Choice "d" is incorrect. A compilation is limited to presenting, in the form of a forecast, information that is management's representation.

QUESTION 142 An attest engagement is one in which a CPA is engaged to:

- A. Issue an examination, a review, or an agreed-upon procedures report on subject matter, or on an assertion about the subject matter, that is the responsibility of another party.
- B. Provide tax advice or prepare a tax return based on financial information the CPA has not audited or reviewed.
- C. Testify as an expert witness in accounting, auditing, or tax matters, given certain stipulated facts.
- D. Assemble the financial statements of a nonissuer based on the assumptions of the entity's management without expressing any assurance.

Correct Answer: A**Section: Auditing and Attestation****Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. An attest engagement is one in which a CPA is engaged to issue an examination, a review, or an agreed-upon procedures report on subject matter, or on an assertion about subject matter, that is the responsibility of another party.

Choice "b" is incorrect. Providing tax advice or preparing a tax return based upon financial information, the CPA has not audited or reviewed does not require the CPA to "attest" to anything.

Choice "c" is incorrect. Testifying as an expert witness in accounting, auditing, or tax matters given certain stipulated facts is not considered to be an attestation engagement.

Choice "d" is incorrect. Assembling the financial statements of a nonissuer based on the assumptions of the entity's management without expressing any assurance is a compilation engagement that falls under SSARS and no attestation is provided.

QUESTION 143 Which of the following professional services would be considered an attest engagement?

- A. A management consulting engagement to provide EDP advice to a client.

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

- B. An engagement to report on management's discussion and analysis (MD&A).
- C. An income tax engagement to prepare federal and state tax returns.
- D. The compilation of financial statements from a client's accounting records.



Correct Answer: B
Section: Auditing and Attestation
Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. An engagement to report on management's discussion and analysis (MD&A) would be considered an attest engagement, because the accountant is issuing an examination, review, or agreed-upon procedures report on another party's assertion.

Choice "a" is incorrect. A management consulting engagement to provide EDP advice to a client is not considered to be an attest engagement, because the accountant is not issuing an examination, review, or agreed-upon procedures report on another party's assertion.

Choice "c" is incorrect. An income tax engagement to prepare federal and state tax returns is not considered to be an attest engagement.

Choice "d" is incorrect. The compilation of financial statements from a client's accounting records (a compilation engagement) is not considered to be an attest engagement. (Note that although a compilation of prospective financial statements is covered under Statements on Standards for Attestation Engagements, the question does not indicate that prospective financial statements are involved).

QUESTION 144 Which of the following statements concerning prospective financial statements is correct?

- A. Only a financial forecast would normally be appropriate for limited use.
- B. Only a financial projection would normally be appropriate for general use.
- C. Any type of prospective financial statements would normally be appropriate for limited use.
- D. Any type of prospective financial statements would normally be appropriate for general use.

Correct Answer: C
Section: Auditing and Attestation
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Any type of prospective financial statements (financial forecasts and financial projections) would normally be appropriate for limited use. Choice

"a" is incorrect. Both financial forecasts and financial projections are appropriate for limited use.

Choice "b" is incorrect. Financial projections are appropriate for limited use only - not for general use.

Choice "d" is incorrect. Normally financial projections are not appropriate for general use, but financial forecasts are.

QUESTION 145 Negative assurance may be expressed when an accountant is requested to report on the:

- A. Compilation of prospective financial statements.
- B. Compliance with the provisions of the Foreign Corrupt Practices Act.
- C. Results of performing a review of management's assertion.
- D. Audit of historical financial statements.

Correct Answer: C
Section: Auditing and Attestation
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Negative assurance may be expressed when an accountant is requested to report on the results of performing a review of management's assertion. Choice

"a" is incorrect. No assurance is provided in a compilation of prospective financial statements.

Choice "b" is incorrect. Whether an entity is in compliance with the provisions of the Foreign Corrupt Practices Act is a legal determination. An accountant may perform an examination or an agreed-upon procedures engagement with respect to such compliance but may not perform a review, and therefore would not express negative assurance.

Choice "d" is incorrect. When reporting on an audit of historical financial statements, negative assurance is not an appropriate reporting option. The auditor must either express an opinion (positive assurance) or disclaim an opinion (no assurance).

QUESTION 146 When an accountant examines a financial forecast that fails to disclose several significant assumptions used to prepare the forecast, the accountant should describe the assumptions in the accountant's report and issue a (an):

- A. "Except for" qualified opinion.

- B. "Subject to" qualified opinion.
- C. Unqualified opinion with a separate explanatory paragraph.
- D. Adverse opinion.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When an accountant examines a financial forecast that fails to disclose significant assumptions used to prepare the forecast, the accountant should issue an adverse opinion.

Choice "a" is incorrect. A qualified opinion might be appropriate when AICPA presentation guidelines are not followed, but would not be used when "several significant assumptions used to prepare the forecast" are not disclosed. Choice

"b" is incorrect. "Subject to" is not acceptable wording for an accountant's report.

Choice "c" is incorrect. An unqualified opinion is not acceptable when significant assumptions are not disclosed.

QUESTION 147

Prospective financial information presented in the format of historical financial statements that omit either gross profit or net income is deemed to be a:

- A. Partial presentation.
- B. Projected balance sheet.
- C. Financial forecast.
- D. Financial projection.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. "Partial presentations" are presentations of prospective financial information which would not ordinarily be appropriate for general use because they omit one or more of these essential elements: (a) sales or gross revenue, (b) gross profit or cost of sales, (c) unusual or infrequently occurring items, (d) provision for income taxes, (e) discontinued operations or extraordinary items, (f) income from continuing operations, (g) net income, (h) earnings per share, and (i) significant changes in financial position.

Choices "b", "c", and "d" are incorrect. Projected balance sheets, financial forecasts and financial projections are forms of prospective financial statements.

QUESTION 148 Which of the following activities would most likely be considered an attestation engagement?

- A. Consulting with management representatives of a firm to provide advice.
- B. Issuing a report about a firm's compliance with laws and regulations.
- C. Advocating a client's position on tax matters that are being reviewed by the IRS.
- D. Preparing a client's tax returns.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Attest engagements may result in reports related to compliance with laws and regulations.

Choices "a", "c", and "d" are incorrect. Attestation engagements specifically exclude consulting services, advocacy services, and return preparation.

QUESTION 149 Which of the following professional services would be considered an attestation engagement?

- A. Advocating on behalf of a client about trust tax matters under review by the Internal Revenue Service.
- B. Providing financial analysis, planning, and capital acquisition services as a part-time, in-house controller.
- C. Advising management in the selection of a computer system to meet business needs.

D. Preparing the income statement and balance sheet for one year in the future based on client expectations and predictions.

Correct Answer: D

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Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Preparing future financial statements constitutes a compilation of prospective financial statements, which is considered to be an attestation service. Choices

"a" and "c" are incorrect. Attestation engagements specifically exclude advocacy services and consulting services.

Choice "b" is incorrect. Attest engagements include those in which a practitioner is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or on an assertion about the subject matter, that is the responsibility of another party, as well as engagements related to prospective financial statements. Performing the role of in-house controller part-time does not fit into any of these categories.

QUESTION 150 When an accountant compiles a financial forecast, the accountant's report should include a(an):

- A. Explanation: of the differences between a financial forecast and a financial projection.
- B. Caveat that the prospective results of the financial forecast may not be achieved.
- C. Statement that the accountant's responsibility to update the report is limited to one year.
- D. Disclaimer of opinion on the reliability of the entity's internal controls.

Correct Answer: B

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Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Whenever an accountant reports on prospective financial statements, the report should include a caveat that prospective results may not be achieved.

Choice "a" is incorrect. A compilation report on a financial forecast does not include an Explanation: of the differences between a forecast and a projection.

Choice "c" is incorrect. Whenever an accountant reports on prospective financial statements, the report should include a statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

Choice "d" is incorrect. A compilation report on a financial forecast does not include a disclaimer of opinion on the reliability of the entity's internal controls.

QUESTION 151

Which of the following is a professional engagement that a CPA may perform to provide assurance on a system's reliability?

- A. MAS AssurAbility.
- B. CPA WebMaster.
- C. MAS AttestSure.
- D. CPA SysTrust.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A SysTrust engagement is an attest engagement that provides assurance on the reliability of any defined electronic system. Choice

"a" is incorrect. There is no professional engagement by this name.

Choice "b" is incorrect. There is no professional engagement by this name.

Choice "c" is incorrect. There is no professional engagement by this name.

QUESTION 152

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.

Correct Answer: B

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Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. An accountant's standard report on a compilation of a projection does not include a statement that the hypothetical assumptions used in the projection are reasonable in the circumstances.

Choice "a" is incorrect. An accountant's standard report on a compilation of a projection does state that there will usually be differences between the forecasted and actual results.

Choice "c" is incorrect. An accountant's standard report on a compilation of a projection does state that the accountant has no responsibility to update the report for future events and circumstances.

Choice "d" is incorrect. An accountant's standard report on a compilation of a projection does state that the compilation of a projection is limited in scope ("A compilation is limited to presenting in the form of a projection information that is the representation of management and does not include evaluation of the support for the assumptions underlying the projection.")

QUESTION 153

Which of the following factors most likely would lead a CPA to conclude that a potential audit engagement should be rejected?

- A. The details of most recorded transactions are not available after a specified period of time.
- B. Internal control activities requiring the segregation of duties are subject to management override.
- C. It is unlikely that sufficient appropriate evidence is available to support an opinion on the financial statements.
- D. Management has a reputation for consulting with several accounting firms about significant accounting issues.

Correct Answer: C

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Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A CPA cannot render an opinion on financial statements unless he or she has obtained sufficient appropriate audit evidence supporting that opinion. If such evidence were unlikely to be available, the CPA would most likely reject the potential audit engagement.

Choice "a" is incorrect. The auditor takes the availability of information into account when planning the audit, and would need to perform testing throughout the period, but this would not be cause for rejecting a potential audit engagement.

Choice "b" is incorrect. The risk of management override is considered during planning and would not be cause for rejecting a potential audit engagement. Choice "d" is incorrect. Management may consult with several accounting firms, and this would not be cause for rejecting a potential audit engagement.

QUESTION 154

Which of the following factors most likely would cause a CPA to decide not to accept a new audit engagement?

- A. The CPA's lack of understanding of the prospective client's internal auditor's computer-assisted audit techniques.
- B. Management's disregard of its responsibility to maintain an adequate internal control environment.
- C. The CPA's inability to determine whether related party transactions were consummated on terms equivalent to arm's-length transactions.
- D. Management's refusal to permit the CPA to perform substantive tests before the year-end.

Correct Answer: B

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Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The control environment is the foundation for all other components of internal control. Management's disregard of its responsibility to maintain an adequate internal control environment therefore compromises its ability to provide reasonable assurance regarding reliable financial reporting. The auditor may conclude that the risk of misrepresentation in the financial statements is great enough that an audit should not be conducted.

Choice "a" is incorrect. The CPA does not need to understand the internal auditor's techniques in order to accept a new audit engagement.

Choice "c" is incorrect. Related party transactions (by definition) are not considered to be arm's-length transactions, and evaluation of such transactions does not affect the CPA's decision regarding acceptance of new clients. Choice

"d" is incorrect. Substantive tests are generally performed after year-end, since prior to that time the financial statements have not been finalized.

QUESTION 155 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.

Correct Answer: A

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Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. An understanding with the client should be established regarding management's responsibilities, which include identifying and ensuring that the entity complies with applicable laws and regulations. The understanding should be documented through a written communication, such as an engagement letter.

Choice "b" is incorrect. Judgments about materiality are the auditor's responsibility and would not be included in an engagement letter.

Choice "c" is incorrect. Management would not necessarily be responsible for illegal acts committed by employees. Choice

"d" is incorrect. The auditor is not responsible for searching for significant internal control deficiencies.

QUESTION 156 Before accepting an engagement to audit a new client, a CPA is required to obtain:

- A. An understanding of the prospective client's industry and business.
- B. The prospective client's signature to the representation letter.
- C. A preliminary understanding of the prospective client's control environment.
- D. The prospective client's consent to make inquiries of the predecessor auditor, if any.

Correct Answer: D

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Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Inquiry of the predecessor auditor is a required pre-acceptance procedure.

However, consent of the prospective client must be obtained before a CPA can make such inquiries of the predecessor auditor.

Choice "a" is incorrect. Obtaining an understanding of the client's industry and business is a planning procedure performed after an engagement is accepted. Choice

"b" is incorrect. A management representation letter is not obtained until the end of the audit.

Choice "c" is incorrect. Obtaining a preliminary understanding of the client's control environment is an audit procedure (required by the second standard of fieldwork) that would be performed after an engagement is accepted.

QUESTION 157 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.

Correct Answer: D

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Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When assessing the internal auditors' objectivity, the auditor should obtain information about whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors.

Choice "a" is incorrect. A quality control program would impact the competence of the internal audit staff, not their objectivity.

Choice "b" is incorrect. Examining documentary evidence produced by the internal auditors would help the auditor evaluate the quality and effectiveness of the internal auditors' work, but would not help assess objectivity.

Choice "c" is incorrect. Testing a sample of transactions and balances examined by the internal auditors would help the auditor evaluate the quality and effectiveness of the internal auditors' work, but would not help assess objectivity.

QUESTION 158

Which of the following auditor concerns most likely could be so serious that the auditor concludes that a financial statement audit cannot be conducted?

- A. The entity has no formal written code of conduct.
- B. The integrity of the entity's management is suspect.
- C. Procedures requiring segregation of duties are subject to management override.
- D. Management fails to modify prescribed controls for changes in conditions.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Serious concerns about the integrity of management may indicate a risk of management misrepresentation in the financial statements that is so great that an audit cannot be conducted. If the integrity of management is suspect, there would be a presumption of dishonesty. The auditor would then need to question the genuineness of all records and documents obtained from the client and would require conclusive rather than persuasive evidence to corroborate all management representations. An audit conducted on these terms would be unreasonably costly and impractical.

Choice "a" is incorrect. A formal written code of conduct is generally considered a positive control, but the lack of one would not preclude an audit from being conducted.

Choice "c" is incorrect. Management override of internal controls (such as segregation of duties) is an inherent limitation of any internal control and would not prevent an audit from being performed.

Choice "d" is incorrect. A failure by management to modify prescribed controls for changes in conditions may increase control risk, but since the auditor can generally compensate for weak internal controls with increased substantive testing, this would not preclude an audit.

QUESTION 159 The work of internal auditors may affect the independent auditor's:

- I. Procedures performed in obtaining an understanding of internal control.
- II. Procedures performed in assessing the risk of material misstatement.
- III. Substantive procedures performed in gathering direct evidence.

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



Correct Answer: D

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Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The internal auditors' work may affect the nature, timing, and extent of the audit, including procedures the auditor performs when obtaining an understanding of the entity's internal control, when assessing risk, and when performing substantive procedures.

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

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

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

QUESTION 160

Which of the following statements is correct concerning an auditor's use of the work of a specialist?

- A. The auditor need not obtain an understanding of the methods and assumptions used by the specialist.
- B. The auditor may not use the work of a specialist in matters material to the fair presentation of the financial statements.
- C. The reasonableness of the specialist's assumptions and their applications are strictly the auditor's responsibility.
- D. The work of a specialist who has a contractual relationship with the client may be acceptable under certain circumstances.

Correct Answer: D

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Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The purpose of using the work of a specialist is to provide the auditor with specialized skill or knowledge the auditor may lack. The work of a specialist who has a relationship with a client may be acceptable under certain circumstances. If the specialist has a relationship with the client, the auditor should assess the risk that the specialist's objectivity might be impaired. If the auditor believes that the relationship might impair the specialist's objectivity, the auditor should perform additional procedures with respect to the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should engage another specialist for that purpose.

Choice "a" is incorrect. Although the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of the methods or assumptions used in order to determine whether the findings are suitable for corroborating the representations in the financial statements.

Choice "b" is incorrect. The auditor may use, and in fact is encouraged to use, the work of a specialist in matters material to the fair presentation of the financial statements.

Choice "c" is incorrect. The appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist; the auditor should, however, obtain an understanding of the methods or assumptions used in order to determine whether the findings are suitable for corroborating the representations in the financial statements.

QUESTION 161

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.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. In order to observe the physical inventory count, the auditor would have to coordinate schedules with the client. This timing is usually agreed upon before implementation of the audit strategy.

Choice "a" is incorrect. It would not be appropriate for the client to be involved in determining the amount of evidence necessary to provide a basis for an opinion.

Choice "b" is incorrect. It would not be appropriate for the client to be involved in determining the procedures necessary to obtain evidence about litigation, claims and assessments.

Choice "c" is incorrect. Determination of the pending legal matters to be included in a letter to the client's attorney would not generally be made during the planning stage of the audit.

QUESTION 162

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



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

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Inquiries should include specific questions regarding, among other things, facts that might bear on the integrity of management; disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters; communications with those charged with governance regarding fraud, illegal acts, and matters relating to internal control; and the predecessor's understanding as to the reasons for the change of auditors. Choice "a" is incorrect. Specialized industry accounting principles might be discussed; however, the successor would be more likely to inquire about items specific to the client.

Choice "b" is incorrect. The competency of the client's internal audit staff might be discussed; however, inquiries of the predecessor auditor regarding the staff are not required. Choice

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

QUESTION 163 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.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The auditor does not consult with the client about audit procedures that will be performed.

Choice "a" is incorrect. Since the engagement letter serves as a contract between the auditor and client, fee arrangements are typically disclosed in the letter.

Choice "b" is incorrect. A discussion regarding possible auditor suggestions is appropriate for inclusion in an engagement letter.

Choice "c" is incorrect. The fact that audit risk exists and that an audit only provides reasonable assurance of the detection of errors and fraud is typically disclosed in an engagement letter.

QUESTION 164

Which of the following procedures would an auditor most likely perform in planning a financial statement audit?

- A. Inquiring of the client's legal counsel concerning pending litigation.
- B. Comparing the financial statements to anticipated results.
- C. Examining computer generated exception reports to verify the effectiveness of internal controls.
- D. Searching for unauthorized transactions that may aid in detecting unrecorded liabilities.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A requirement during planning is to perform analytical procedures, which involve comparisons of recorded amounts to expectations.

Choice "a" is incorrect. Inquiry of the client's legal counsel is typically performed near the end of fieldwork.

Choice "c" is incorrect. Tests of controls are performed after audit planning is complete.

Choice "d" is incorrect. The search for unrecorded liabilities is generally performed at or after year-end.

QUESTION 165

The in-charge auditor most likely would have a supervisory responsibility to explain to the staff assistants:

- A. That fraud is not to be reported to those charged with governance.
- B. How the results of various auditing procedures performed by the assistants should be evaluated.
- C. What benefits may be attained by the assistants' adherence to established time budgets.
- D. Why certain documents are being transferred from the current file to the permanent file.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Assistants should be informed of their responsibilities and the objectives of the procedures that they are to perform. Part of the assistant's responsibility is to properly evaluate audit results, and the in-charge auditor would likely discuss this with them.

Choice "a" is incorrect. Fraud that causes a material misstatement or involves senior management should be reported to those charged with governance.

Choice "c" is incorrect. Preparation and maintenance of the time budget is related to planning rather than supervision.

Choice "d" is incorrect. The reasons for transferring documents from the permanent file to the current file need not be explained to the staff assistants.

QUESTION 166 Analytical procedures used in planning an audit should focus on:

- A. Reducing the scope of tests of controls and substantive tests.
- B. Providing assurance that potential material misstatements will be identified.
- C. Enhancing the auditor's understanding of the client's business.
- D. Assessing the adequacy of the available audit evidence.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Analytical procedures used in planning the audit should focus on enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date. Choice

"a" is incorrect. Analytical procedures used in planning do not reduce tests of controls or substantive tests.

Choice "b" is incorrect. Analytical procedures used in planning are not designed to identify material misstatements.

Choice "d" is incorrect. Audit evidence has not yet been gathered during the planning process, so its adequacy cannot be assessed.

QUESTION 167

Which of the following relatively small misstatements most likely could have a material effect on an entity's financial statements?

- A. An illegal payment to a foreign official that was not recorded.
- B. A piece of obsolete office equipment that was not retired.
- C. A petty cash fund disbursement that was not properly authorized.
- D. An uncollectible account receivable that was not written off.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. An illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

Choice "b" is incorrect. Failure to retire a piece of obsolete office equipment is not likely to have ramifications beyond the immaterial misstatement that would result directly from it.

Choice "c" is incorrect. Failure to properly authorize a petty cash fund disbursement is not likely to have ramifications beyond the immaterial misstatement that would result directly from it.

Choice "d" is incorrect. Failure to write off a relatively small uncollectible account receivable is not likely to have ramifications beyond the immaterial misstatement that would result directly from it.

QUESTION 168

Which of the following risks may be assessed in nonquantitative terms?

	<u>Control risk</u>	<u>Detection risk</u>	<u>Inherent risk</u>
A	Yes	Yes	No
B	Yes	No	Yes
C	Yes	Yes	Yes
D	No	Yes	Yes



- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Both the risk of material misstatement (including control risk and inherent risk) and detection risk may be assessed in quantitative terms such as percentages or in nonquantitative terms that range, for example, from a minimum to a maximum.

Choices "a", "b", and "d" are incorrect, based on the above explanation.

QUESTION 169

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.

Correct Answer: B
Section: Auditing and Attestation
Explanation

Explanation/Reference:

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 170 An auditor should design the written audit plan so that:

- A. All material transactions will be selected for substantive testing.
- B. Substantive tests prior to the balance sheet date will be minimized.
- C. The audit procedures selected will achieve specific audit objectives.
- D. Each account balance will be tested under either tests of controls or tests of transactions.

Correct Answer: C
Section: Auditing and Attestation
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. An audit plan aids in instructing assistants in the work to be done. It should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit. Choice "a" is incorrect. Auditors make extensive use of sampling to perform audit tests. Tests of all material transactions would not be economically feasible.

Choice "b" is incorrect. Assuming that incremental risk can be controlled, substantive tests can be performed prior to year-end.

Choice "d" is incorrect. An account balance does not necessarily have to have tests of controls or tests of transactions applied to it.

QUESTION 171

In auditing the financial statements of Star Corp., Land discovered information leading Land to believe that Star's prior year's financial statements, which were audited by Tell, require substantial revisions. Under these circumstances, Land should:

- A. Notify Star's audit committee and stockholders that the prior year's financial statements cannot be relied on.
- B. Request Star to reissue the prior year's financial statements with the appropriate revisions.
- C. Notify Tell about the information and make inquiries about the integrity of Star's management.
- D. Request Star to arrange a meeting among the three parties to resolve the matter.

Correct Answer: D
Section: Auditing and Attestation
Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. If, during the audit, the successor auditor becomes aware of information indicating that the financial statements reported on by the predecessor auditor may require revision, he or she should request the client to arrange a meeting among the three parties to discuss the information and attempt to resolve the matter.

Choice "a" is incorrect. It is not the successor auditor's responsibility to inform readers that the financial statements, which were audited by another firm, cannot be relied upon.

Choice "b" is incorrect. The prior year's financial statements should not be reissued until the two auditing firms and the client have an opportunity to discuss the matter. There is a reasonable likelihood that the successor firm is unaware of other information that supports the current condition of the prior year financial statements.

Choice "c" is incorrect. The successor firm should not notify the predecessor directly but should request that the client do so.

QUESTION 172 An internal auditor's work would most likely affect the nature, timing, and extent of an independent CPA's auditing procedures when the internal auditor's work relates to assertions about the:

- A. Existence of contingencies.
- B. Valuation of intangible assets.
- C. Existence of fixed asset additions.

D. Valuation of related party transactions.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. In making judgments about the extent of the effect of the internal auditor's work on the auditor's procedures, the auditor considers the materiality of financial statement amounts, the risk of material misstatement of the assertions related to these financial statement amounts, and the degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the assertions. As the degree of subjectivity increases, the need for the auditor to perform tests of the assertions increases.

Testing the existence of fixed asset additions involves very little subjectivity, and thus work performed by the internal auditor may reduce the auditor's testing in this area.

Choice "a" is incorrect. Testing the existence of contingencies involves much subjectivity, and should, therefore, be performed by the auditor.

Choice "b" is incorrect. Testing the valuation of intangible assets involves much subjectivity, and should, therefore, be performed by the auditor.

Choice "d" is incorrect. Testing the valuation of related party transactions involves much subjectivity, and should, therefore, be performed by the auditor.

QUESTION 173

During an audit an internal auditor may provide direct assistance to an independent CPA in:

	<i>Obtaining an understanding of internal control</i>	<i>Performing tests of controls</i>	<i>Performing substantive tests</i>
A	No	No	No
B	Yes	No	No
C	Yes	Yes	No
D	Yes	Yes	Yes



- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Internal auditors may assist the auditor in obtaining an understanding of internal control and in performing tests of controls and substantive tests. Choices "a", "b", and "c" are incorrect, based on the above explanation.

QUESTION 174

Which of the following statements is correct concerning an auditor's use of the work of a specialist?

- A. The work of a specialist who is related to the client may be acceptable under certain circumstances.
- B. If an auditor believes that the determinations made by a specialist are unreasonable, only a qualified opinion may be issued.
- C. If there is a material difference between a specialist's findings and the assertions in the financial statements, only an adverse opinion may be issued.
- D. An auditor may not use a specialist in the determination of physical characteristics relating to inventories.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The work of a specialist who has a relationship with a client may be acceptable under certain circumstances. If the specialist is related to the client, the auditor should consider performing additional procedures with respect to the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable, or should engage another specialist for that purpose.

Choice "b" is incorrect. If the auditor believes the findings are unreasonable, the auditor should apply additional procedures, which may include obtaining the opinion of another specialist. This does not imply that there is a problem with the financial statements, and therefore would not necessarily result in a qualified opinion.

Choice "c" is incorrect. If there is a material difference between a specialist's findings and the assertions in the financial statements, and if the specialist's findings are deemed reasonable, either a qualified or an adverse opinion may be issued. (Note that it is also possible that the specialist's findings turn out to be erroneous, in which case an unqualified opinion might be issued.) Choice "d" is incorrect. A specialist may be used to determine the physical characteristics relating to inventory (e.g., quantity on hand or condition).

QUESTION 175

In using the work of a specialist, an auditor of a nonissuer may refer to the specialist in the auditor's report if, as a result of the specialist's findings, the auditor:

- A. Becomes aware of conditions causing substantial doubt about the entity's ability to continue as a going concern.
- B. Desires to disclose the specialist's findings, which imply that a more thorough audit was performed.
- C. Is able to corroborate another specialist's earlier findings that were consistent with management's representations.
- D. Discovers significant deficiencies in the design of the entity's internal control that management does not correct.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to the auditor's standard report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.

Choice "b" is incorrect. The auditor should not refer to the work or findings of the specialist unless the specialist's work results in a change to the auditor's report.

Choice "c" is incorrect. The auditor should not refer to the work or findings of the specialist unless the specialist's work results in a change to the auditor's report.

Choice "d" is incorrect. The identification of significant deficiencies in the design of the client's internal control would not result in a change to the auditor's report. The auditor should not refer to the work or findings of the specialist unless the specialist's work results in a change to the auditor's report.

QUESTION 176

Which of the following procedures would an auditor most likely include in the initial planning of a financial statement audit?

- A. Obtaining a written representation letter from the client's management.
- B. Examining documents to detect illegal acts having a material effect on the financial statements.
- C. Considering whether the client's accounting estimates are reasonable in the circumstances.
- D. Determining the extent of involvement of the client's internal auditors.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The auditor considers several factors in planning the nature, timing and extent of auditing procedures. One of these factors is the extent of involvement of the client's internal auditors. Choice

"a" is incorrect. Representation letters are obtained by the auditor at the end of the audit. The representation letter should not be dated earlier than the date of the auditor's report.

Choice "b" is incorrect. The auditor does not perform tests to detect illegal acts during the planning process.

Choice "c" is incorrect. The auditor does obtain and evaluate evidence to support significant accounting estimates, but this occurs subsequent to initial planning.

QUESTION 177

Which of the following factors most likely would influence an auditor's determination of the auditability of an entity's financial statements?

- A. The complexity of the information system relevant to financial reporting.
- B. The existence of related party transactions.
- C. The adequacy of the accounting records.
- D. The operating effectiveness of controls.

Correct Answer: C

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. Inadequate financial records may preclude the auditor from obtaining sufficient appropriate audit evidence.

Choice "a" is incorrect. The complexity of the client's information system generally would not influence an auditor's determination of auditability, although it might indicate the need for an information technology expert.

Choice "b" is incorrect. The existence of related party transactions generally would not influence the auditor's determination of auditability. Choice "d" is incorrect. The operating effectiveness of internal controls is determined long after the decision about auditability is made.

QUESTION 178

Hill, CPA, has been retained to audit the financial statements of Monday Co. Monday's predecessor auditor was Post, CPA, who has been notified by Monday that Post's services have been terminated.

Under these circumstances, which party should initiate the communications between Hill and Post?

- A. Hill, the successor auditor.
- B. Post, the predecessor auditor.
- C. Monday's controller or CFO.
- D. The chairman of Monday's board of directors.

Correct Answer: A

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. The initiative to communicate with the predecessor auditor rests with the successor auditor. Note, however, that the successor auditor must first receive permission from the client.

Choice "b" is incorrect. The predecessor auditor should respond promptly and fully to reasonable inquiries. However, the predecessor is not responsible for initiating communications.

Choice "c" is incorrect. The prospective client should authorize the predecessor to respond fully to the successor's inquiries. However, the client is not responsible for initiating communications.

Choice "d" is incorrect. The prospective client should authorize the predecessor to respond fully to the successor's inquiries. However, the client is not responsible for initiating communications.

QUESTION 179

The senior auditor responsible for coordinating the fieldwork usually schedules a pre-audit conference with the audit team primarily to:

- A. Give guidance to the staff regarding both technical and personnel aspects of the audit.
- B. Discuss staff suggestions concerning the establishment and maintenance of time budgets.
- C. Establish the need for using the work of specialists and internal auditors.
- D. Provide an opportunity to document staff disagreements regarding technical issues.

Correct Answer: A

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. Pre-audit planning meetings are typically held to plan technical and personnel aspects of the audit. Assistants should be informed of their responsibilities and the objectives of the procedures that they are to perform.

Choice "b" is incorrect. While staff suggestions regarding time budgets may be discussed, this is not typically the primary reason for the meeting.

Choice "c" is incorrect. Establishing the need for specialists and internal auditors may be discussed, but this is not the primary reason for the meeting. Choice

"d" is incorrect. Disagreements about technical issues arise and are resolved after testing begins, not during the pre-audit conference.

QUESTION 180

To obtain an understanding of a continuing client's business in planning an audit, an auditor most likely would:

- A. Perform tests of details of transactions and balances.
- B. Review prior-year audit documentation and the permanent file for the client.
- C. Read specialized industry journals.
- D. Reevaluate the client's internal control environment.

Correct Answer: B

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Knowledge of an entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of personnel of the entity. Audit documentation from prior years may contain useful information about the nature of the business, its organizational structure, its operating characteristics, and transactions that may require special consideration.

Choice "a" is incorrect. Tests of details of transactions and balances are not performed during the planning stage of an audit.

Choice "c" is incorrect. Reading industry journals would provide information about the industry in which the entity operates, but reviewing prior-year audit documentation and the permanent file would provide a more thorough understanding of the specific client's business.

Choice "d" is incorrect. The client's internal control is not reevaluated during the planning stage of an audit.

QUESTION 181

In planning an audit of a new client, an auditor most likely would consider the methods used to process accounting information because such methods:

- A. Influence the design of internal control.
- B. Affect the auditor's preliminary judgment about materiality levels.
- C. Assist in evaluating the planned audit objectives.
- D. Determine the auditor's acceptable level of audit risk.

Correct Answer: A

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. The auditor should consider the methods the entity uses to process accounting information in planning the audit because such methods influence the design of internal control. The extent to which computer processing is used in significant accounting applications, as well as the complexity of the processing, may also influence the nature, timing, and extent of audit procedures.

Choice "b" is incorrect. Materiality is a matter of professional judgment and is influenced by the auditor's perceptions of the needs of a reasonable person. It would not be affected by the methods used to process accounting information.

Choice "c" is incorrect. The auditor develops specific audit objectives based on financial statement assertions. The methods used to process accounting information would not be relevant to the development of objectives.

Choice "d" is incorrect. Audit risk is the risk that the auditor may unknowingly fail to modify the opinion on financial statements that are materially misstated. The acceptable level of audit risk is a matter of auditor judgment, but it would not be affected by the methods used to process accounting information.

QUESTION 182

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.

Correct Answer: D

Section: Auditing and Attestation**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. The existence of audit risk is recognized by the statement in the standard report that the auditor obtained reasonable assurance about whether the financial statements are free of material misstatement. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated.

Choice "a" is incorrect. This statement defines the distinction between the responsibility of the auditor and that of management.

Choice "b" is incorrect. The purpose of this section is to note that fair presentation is not necessarily impacted by immaterial errors. Choice

"c" is incorrect. This statement explains the nature of an audit.

QUESTION 183 Which of the following statements is not correct

about materiality?

- A. The concept of materiality recognizes that some matters are important for fair presentation of financial statements in conformity with GAAP, while other matters are not important.
- B. An auditor considers materiality for planning purposes in terms of the largest aggregate level of misstatements that could be material to any one of the financial statements.
- C. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative judgments.

D. An auditor's consideration of materiality is influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Materiality levels include an overall level for each statement; however, because the statements are interrelated, and for reasons of efficiency, the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatements that could be considered material to any one of the financial statements.

Choice "a" is incorrect. The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for the fair presentation of financial statements in conformity with GAAP, while other matters are not important.

Choice "c" is incorrect. Materiality judgments are made in light of the surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

Choice "d" is incorrect. The auditor's consideration of materiality is influenced by his or her perception of the needs of a reasonable person relying on the financial statements.

QUESTION 184

Which of the following documentation is not required for an audit in accordance with generally accepted auditing standards?

- A. A written audit plan setting forth the procedures necessary to accomplish the audit's objectives.
- B. An indication that the accounting records agree or reconcile with the financial statements.
- C. A client engagement letter that summarizes the timing and details of the auditor's planned fieldwork.
- D. The basis for the auditor's decision not to perform tests of controls concurrently with obtaining an understanding of internal control.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The auditor is not required to evaluate operating effectiveness as part of obtaining an understanding of internal control, and therefore need not document the basis for this decision. Choice "a" is incorrect. The auditor is required to prepare a written audit plan.

Choice "b" is incorrect. Audit documentation should be sufficient to show that the accounting records agree or reconcile with the financial statements.

Choice "c" is incorrect. Establishing an understanding with the client is required by GAAS, and an engagement letter is a presumptively mandatory requirement.

QUESTION 185

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

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

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

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

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

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

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

QUESTION 186 Which of the following statements is correct about the auditor's use of the work of a specialist?

- A. The specialist should not have an understanding of the auditor's corroborative use of the specialist's findings.

- B. The auditor is required to perform substantive procedures to verify the specialist's assumptions and findings.
- C. The client should not have an understanding of the nature of the work to be performed by the specialist.
- D. The auditor should obtain an understanding of the methods and assumptions used by the specialist.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Although the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of the methods or assumptions used in order to determine whether the findings are suitable for corroborating the representations in the financial statements.

Choice "a" is incorrect. An understanding should exist among the auditor, the client, and the specialist as to the nature of the work to be performed.

Choice "b" is incorrect. The auditor may consider performing substantive procedures to verify the specialist's findings if the specialist is related to the client, but is not required to do so. Choice "c" is incorrect. An understanding should exist among the auditor, the client, and the specialist as to the nature of the work to be performed.

QUESTION 187

In assessing the competence and objectivity of an entity's internal auditor, an independent auditor least likely would consider information obtained from:

- A. Discussions with management personnel.
- B. External quality reviews of the internal auditor's activities.
- C. Previous experience with the internal auditor.
- D. The results of analytical procedures.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Analytical procedures may be used to enhance the auditor's understanding of the client's business or to evaluate financial statement assertions, but generally would not be helpful in assessing the competence and objectivity of an entity's internal auditor.

Choice "a" is incorrect. In assessing competence and objectivity, the auditor usually considers information obtained from discussions with management personnel.

Choice "b" is incorrect. In assessing competence and objectivity, the auditor usually considers information obtained from external quality reviews of internal audit activities.

Choice "c" is incorrect. In assessing competence and objectivity, the auditor usually considers information obtained from previous experience with the internal audit function.

QUESTION 188

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

- A. Opinion of any subsequent events occurring since the predecessor's audit report was issued.
- B. Understanding as to the reasons for the change of auditors.
- C. Awareness of the consistency in the application of GAAP between periods.
- D. Evaluation of all matters of continuing accounting significance.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Before accepting an engagement, the auditor should make specific inquiries of the predecessor auditor in order to assist the auditor in deciding whether or not to accept the engagement. Inquiry should include the predecessor's understanding of the reasons for the change in auditors.

Choice "a" is incorrect. The predecessor generally does not provide an opinion on events occurring subsequent to the issuance of the audit report.

Choice "c" is incorrect. The successor (and not the predecessor) evaluates the consistency in the application of GAAP. This evaluation occurs after acceptance.

Choice "d" is incorrect. The predecessor generally allows the successor to review audit documentation related to matters of continuing accounting significance, but this occurs subsequent to acceptance.

QUESTION 189

Which of the following factors most likely would cause an auditor not to accept a new audit engagement?

- A. An inadequate understanding of the entity's internal control.
- B. The close proximity to the end of the entity's fiscal year.
- C. Concluding that the entity's management probably lacks integrity.
- D. An inability to perform preliminary analytical procedures before accepting the engagement.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A conclusion that management lacks integrity would probably cause the auditor not to accept a new engagement.

Choice "a" is incorrect. Inadequate understanding of the client's internal control would not prevent the auditor from accepting the engagement, since that understanding could be obtained later.

Choice "b" is incorrect. Proximity to year-end would not prevent an auditor from accepting a new audit engagement.

Choice "d" is incorrect. While analytical procedures are required during planning, this generally occurs subsequent to accepting the engagement.

QUESTION 190

The audit work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the:

- A. Auditor's system of quality control has been maintained at a high level.
- B. Results are consistent with the conclusions to be presented in the auditor's report.
- C. Audit procedures performed are approved in the professional standards.
- D. Audit has been performed by persons having adequate technical training and proficiency as auditors.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Review of assistants' work is necessary to determine whether it was performed in a satisfactory manner and to determine whether the work supports the conclusions presented in the auditor's report.

Choice "a" is incorrect. The responsibility of a firm to establish review procedures (a system of quality control) is distinct from the auditor's responsibility to adequately plan and supervise the work on a particular engagement. Quality control standards relate to the conduct of the firm's audit practice as a whole; GAAS relates to the conduct of individual audits.

Choice "c" is incorrect. Specific audit procedures are performed based on the auditor's judgment and would not necessarily be approved in the professional standards.

Choice "d" is incorrect. Review of an assistant's work would not necessarily be indicative of that assistant's technical training and proficiency. The review process is to determine whether the audit is being performed in a satisfactory manner.

QUESTION 191 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.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The auditor should obtain knowledge of the client's business and its industry in order to determine the effect of transactions, events, and practices on the client's financial statements.

Choice "a" is incorrect. Constructive suggestions concerning improvements in the new client's internal control are generally made after the study and evaluation of the client's internal control, performed subsequent to planning. Knowledge about the new client's business and its industry is generally obtained during planning.

Choice "b" is incorrect. The auditor should have an attitude of professional skepticism in conducting the engagement, but this attitude is not necessarily related to the auditor's knowledge of the new client's business and its industry.

Choice "c" is incorrect. The auditor should evaluate whether the aggregation of known misstatements materially affects the financial statements, but this is done near the audit's conclusion. Knowledge about the new client's business and its industry is generally obtained during planning.

QUESTION 192

The objective of performing analytical procedures in planning an audit is to identify the existence of:

- A. Unusual transactions and events.
- B. Illegal acts that went undetected because of internal control weaknesses.
- C. Related party transactions.
- D. Recorded transactions that were not properly authorized.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The objective of performing analytical procedures during planning is to discover unusual transactions or events that may have an impact on the planning of the financial statement audit.

Choice "b" is incorrect. Analytical procedures are not effective in identifying illegal acts that went undetected due to internal control weaknesses.

Choice "c" is incorrect. Analytical procedures are not effective in identifying related party transactions.

Choice "d" is incorrect. Analytical procedures are not effective as tests of controls to identify unauthorized transactions.

QUESTION 193

Which of the following is required documentation in an audit in accordance with generally accepted auditing standards?

- A. A flowchart or narrative of the information system relevant to financial reporting describing the recording and classification of transactions for financial reporting.
- B. An audit plan setting forth in detail the procedures necessary to accomplish the engagement's objectives.
- C. A planning memorandum establishing the timing of the audit procedures and coordinating the assistance of entity personnel.
- D. An internal control questionnaire identifying controls that assure specific objectives will be achieved.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. In an audit conducted in accordance with GAAS, the auditor must document the audit plan, setting forth in detail the procedures necessary to accomplish the engagement's objectives.

Choice "a" is incorrect. Documentation of the auditor's understanding of the client's internal control is required, but may take different forms. A narrative, an internal control questionnaire, a flowchart, or simply a memorandum (for a small client) may be sufficient.

Choice "c" is incorrect. A planning memo, while recommended, is not required under GAAS.

Choice "d" is incorrect. Documentation of the auditor's understanding of the client's internal control is required, but may take different forms: narrative, internal control questionnaire, flowchart, or simply a memorandum (for a small client) may be sufficient. In addition, controls do not assure the achievement of objectives.

QUESTION 194

In using the work of a specialist, an auditor referred to the specialist's findings in the auditor's report. This would be an appropriate reporting practice if the:

- A. Client is not familiar with the professional certification, personal reputation, or particular competence of the specialist.
- B. Auditor, as a result of the specialist's findings, adds an explanatory paragraph emphasizing a matter regarding the financial statements.
- C. Auditor understands the form and content of the specialist's findings in relation to the representations in the financial statements.
- D. Auditor, as a result of the specialist's findings, decides to indicate a division of responsibility with the specialist.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. When expressing an unqualified opinion, the auditor generally will not refer to the work or findings of a specialist. The auditor may, however, make reference to a specialist in an explanatory paragraph if such a reference will facilitate understanding of the explanatory paragraph or of the departure from an unqualified opinion.

Choice "a" is incorrect. Lack of client familiarity with the specialist does not affect the auditor's report. Also, it is the auditor (not the client) who must be satisfied regarding the specialist's qualifications.

Choice "c" is incorrect. The auditor must understand the form and content of the specialist's findings in relation to the representations in the financial statements to be able to review the specialist's work. However, this does not affect whether or not the auditor refers to the specialist in the auditor's report.

Choice "d" is incorrect. An auditor should not divide responsibility for the audit with a specialist. Further, making reference to the specialist in an unmodified unqualified report generally is inappropriate.

QUESTION 195

The auditor with final responsibility for an engagement and one of the assistants have a difference of opinion about the results of an auditing procedure. If the assistant believes it is necessary to be disassociated from the matter's resolution, the CPA firm's procedures should enable the assistant to:

- A. Refer the disagreement to the AICPA's Quality Review Committee.
- B. Document the details of the disagreement with the conclusion reached.
- C. Discuss the disagreement with the entity's management or its audit committee.
- D. Report the disagreement to an impartial peer review monitoring team.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Each assistant has a professional responsibility to bring to the attention of appropriate individuals in the firm, disagreements or concerns the assistant might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or auditor's report. In addition, each assistant should have a right to document his or her disagreement if he or she believes it is necessary to be disassociated from the resolution of the matter.

Choice "a" is incorrect. Quality control committees are primarily concerned with determining whether quality control policies and procedures are being effectively applied. Generally, they would not get involved with disagreements related to specific engagements.

Choice "c" is incorrect. Disagreements among an audit firm's staff would generally be handled internally. Discussion of such matters with the client would be inappropriate.

Choice "d" is incorrect. Impartial peer review teams are primarily concerned with determining whether quality control policies and procedures are being effectively applied. Generally, they would not get involved with disagreements related to specific engagements.

QUESTION 196 Before accepting an engagement to audit a new client, an auditor is required to:

- A. Make inquiries of the predecessor auditor after obtaining the consent of the prospective client.
- B. Obtain an understanding of the entity and its environment, including its internal control.
- C. Prepare a memorandum setting forth the staffing requirements and documenting the preliminary audit plan.
- D. Discuss the management representation letter with the prospective client's audit committee.



Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Prior to acceptance of a new engagement, an auditor must attempt to communicate with the predecessor auditor. Inquiry is important because the predecessor auditor may provide information critical to the acceptance decision. Under the Rules of the Code of Professional Conduct, the auditor must first request the client's permission.

Choice "b" is incorrect. Although the auditor is required to obtain an understanding of the entity and its environment, including its internal control, this typically happens after the engagement is accepted, not before.

Choice "c" is incorrect. A planning memo setting forth staff requirements and documenting the preliminary audit plan is usually prepared after accepting an engagement. Choice "d" is incorrect. A management representation letter is usually obtained at the conclusion of the audit and is dated as of the date of auditor's report.

QUESTION 197

In considering materiality for planning purposes, an auditor believes that misstatements aggregating \$10,000 would have a material effect on an entity's income statement, but that misstatements would have to aggregate \$20,000 to materially affect the balance sheet. Ordinarily, it would be appropriate to design auditing procedures that would be expected to detect misstatements that aggregate:

- A. \$10,000
- B. \$15,000
- C. \$20,000
- D. \$30,000

Correct Answer: A

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Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Because the statements are interrelated, the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatement that could be considered material to any one of the financial statements.

Choices "b", "c", and "d" are incorrect, based on the above explanation.

QUESTION 198 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.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

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 199

For which of the following judgments may an independent auditor share responsibility with an entity's internal auditor who is assessed to be both competent and objective?



	<i>Materiality of misstatements</i>	<i>Evaluation of accounting estimates</i>
A	Yes	No
B	No	Yes
C	No	No
D	Yes	Yes

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: C

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Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Because the auditor has the ultimate responsibility to express an opinion on the financial statements, judgments about assessments of risk, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the auditor. Choices "a", "b", and "d" are incorrect, based on the above explanation.

QUESTION 200

Which of the following procedures would an auditor least likely perform in planning a financial statement audit?

- A. Coordinating the assistance of entity personnel in data preparation.

- B. Discussing matters that may affect the audit with firm personnel responsible for non-audit services to the entity.
- C. Selecting a sample of vendors' invoices for comparison to receiving reports.
- D. Reading the current year's interim financial statements.

Correct Answer: C

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Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Selecting a sample of vendors' invoices for comparison to receiving reports is performed during fieldwork. This is not part of the planning phase.

Choice "a" is incorrect. Coordinating the assistance of entity personnel in data preparation is usually performed during the planning phase.

Choice "b" is incorrect. During the planning phase, matters that may affect the audit should be discussed with firm personnel responsible for non-audit services to the entity.

Choice "d" is incorrect. During the planning phase, the auditor generally would read the current year's interim financial statements.

QUESTION 201

When assessing an internal auditor's competence, a CPA ordinarily obtains information about all of the following, except:

- A. Quality of audit documentation.
- B. Educational level and professional experience.
- C. The audit plan and audit procedures.
- D. Access to information about related parties.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The degree of access the independent auditor has to information about related parties provides no information regarding an internal auditor's competence.

Choice "a" is incorrect. In evaluating the work of internal auditors, the independent auditor should examine, on a test basis, documentary evidence of the work performed by internal auditors and should consider such factors as whether the scope of the work is appropriate, the audit plan is adequate, audit documentation adequately documents work performed, conclusions reached are appropriate in the circumstances, and any reports prepared are consistent with the results of the work performed.

Choice "b" is incorrect. When considering the competence of internal auditors, the independent auditor should inquire about the qualifications of the internal audit staff, including for example, consideration of the client's practices for hiring, training, and supervising internal audit staff. This includes inquiries as to the internal auditor's educational level and professional experience.

Choice "c" is incorrect. In evaluating the work of internal auditors, the independent auditor should examine, on a test basis, documentary evidence of the work performed by internal auditors and should consider such factors as whether the scope of the work is appropriate, the audit plan is adequate, audit documentation adequately documents work performed, conclusions reached are appropriate in the circumstances, and any reports prepared are consistent with the results of the work performed.

QUESTION 202 When an auditor increases the assessed level of control risk because certain control activities were determined to be ineffective, the auditor most likely would increase the:

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

Correct Answer: B

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Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. An increase in the assessed level of control risk means that the assessed risk of material misstatement has also increased, and this requires a corresponding decrease in detection risk to maintain the same (presumably low) level of overall audit risk. Increasing the extent of tests of details will result in a reduction in detection risk.

Choice "a" is incorrect. Increasing detection risk would result in a corresponding increase in overall audit risk, which is the opposite of the desired response.

Choice "c" is incorrect. The auditor cannot change the level of inherent risk, which is based on the nature of the related assertion.

Choice "d" is incorrect. If the auditor has already determined that certain control activities are ineffective, increasing the extent of those tests is not likely to be helpful. The auditor needs to find a way to compensate for the increased level of risk in order to keep overall audit risk to a low level.

QUESTION 203

A CPA wishes to determine how various publicly-held companies have complied with the disclosure requirements in a Statement of Financial Accounting Standards. Which of the following information sources would the CPA most likely consult for this information?

- A. AICPA Accounting Trends & Techniques.
- B. FASB Technical Bulletins.
- C. AICPA Audit and Accounting Manual.
- D. FASB Statements of Financial Accounting Concepts.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The AICPA's Accounting Trends & Techniques is an annual survey of accounting practices followed in 600 stockholders' annual reports.

Choice "b" is incorrect. FASB Technical Bulletins are considered to be a source of established accounting principles that expand upon or further clarify GAAP. They do not provide information regarding how various companies comply with GAAP.

Choice "c" is incorrect. AICPA Audit and Accounting Guides are interpretive publications that provide additional guidance regarding the application of auditing standards. They do not provide information regarding how various companies comply with GAAP.

Choice "d" is incorrect. FASB Statements of Financial Accounting Concepts establish the objectives and concepts for use by the FASB in developing accounting and reporting standards. They do not provide information regarding how various companies comply with GAAP.

QUESTION 204

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.

Correct Answer: D

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Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Ordinarily, audit planning does not require an understanding of the control activities related to each account balance, transaction class, and disclosure component in the FS or to every assertion relevant to them. Choice "a" is incorrect. The auditor is required to understand significant classes of transactions and how they are processed.

Choice "b" is incorrect. The auditor is required to understand the financial reporting process.

Choice "c" is incorrect. The auditor is required to understand the methods used by the entity to communicate matters relevant to financial reporting.

QUESTION 205

Which of the following information discovered during an audit most likely would raise a question concerning possible illegal acts?

- A. Related party transactions, although properly disclosed, were pervasive during the year.
- B. The entity prepared several large checks payable to cash during the year.
- C. Material internal control weaknesses previously reported to management were not corrected.
- D. The entity was a campaign contributor to several local political candidates during the year.

Correct Answer: B

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Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Information that may raise a question concerning possible illegal acts include unusually large payments made to:

- Cash
- Bearer
- Purchase cashiers checks
- Transfer funds to numbered accounts

Choice "a" is incorrect. Related party transactions may provide an indication of fraud, particularly if not made in the ordinary course of business, but they are generally not indicative of illegal acts.

Choice "c" is incorrect. Failure to correct material internal control weaknesses may represent a conscious decision by management to accept that degree of risk because of cost or other considerations. Choice "d" is incorrect. Contributions to local political candidates are legal and generally would not raise a question about possible illegal acts.

QUESTION 206 Which of the following is not a control environment factor?

- A. Participation of those charged with governance.
- B. Hiring and advancement policies.
- C. Management's approach toward business risks.
- D. Proper segregation of duties.

Correct Answer: D

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Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Policies and procedures involving segregation of duties are control activities, not control environment factors.

Choice "a" is incorrect. Participation of those charged with governance is a control environment factor. Choice "b" is incorrect. Hiring and advancement policies are part of human resource policies and practices, which are control environment factors.

Choice "c" is incorrect. Management's approach toward business risks is part of its philosophy and operating style, which is a control environment factor.

QUESTION 207

An auditor who discovers that a client's employees have paid small bribes to public officials most likely would withdraw from the engagement if the:

- A. Client receives financial assistance from a federal government agency.
- B. Audit evidence that is necessary to prove that the illegal acts were committed does not exist.
- C. Employees' actions affect the auditor's ability to rely on management's representations.
- D. Notes to the financial statements fail to disclose the employees' actions.

Correct Answer: C

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Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. When an auditor cannot rely on management's representations, he or she should withdraw from the engagement.

Choice "a" is incorrect. As long as the client takes appropriate remedial action, the auditor would not need to withdraw from the engagement simply because the client receives federal financial assistance.

However, the auditor would be subject to a variety of reporting requirements related to this discovery.

Choice "b" is incorrect. If there is no evidence that an illegal act was committed, management may be unable to take remedial action against the related employees. As long as the illegal act is immaterial and the auditor is satisfied that management's response is appropriate in the circumstances, there would be no reason for the auditor to withdraw.

Choice "d" is incorrect. The auditor should evaluate the adequacy of disclosure in the financial statements with respect to the potential effects of an illegal act. If the auditor concludes that disclosure is inadequate, he or she should express a qualified or adverse opinion, but would not necessarily need to withdraw from the engagement (unless the client refused to accept the modified report).

QUESTION 208

Which of the following statements is true regarding the risk assessment component of internal control?

- A. An auditor evaluates an entity's risk assessment because it is a component of overall audit risk in a financial statement audit.
- B. An auditor's evaluation of an entity's risk assessment may not be applicable to the audit of every entity.
- C. An auditor evaluates an entity's risk assessment to understand how management addresses risks relevant to financial reporting.

D. An auditor need not consider an entity's risk assessment because he or she is primarily concerned with audit risk in a financial statement audit.

Correct Answer: C

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Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The auditor needs to understand how management addresses risks relevant to financial reporting in order to properly plan the audit. Choice

"a" is incorrect. An entity's risk assessment differs from an auditor's assessment of audit risk.

The entity is concerned with managing risks that affect entity objectives (financial reporting, operations, and compliance) whereas the auditor is concerned with the risk that material misstatements could occur in the financial statements.

Choice "b" is incorrect. The five components of internal control are applicable to the audit of every entity.

Choice "d" is incorrect. The auditor needs to understand how management addresses risks relevant to financial reporting in order to properly plan the audit.

QUESTION 209

Before applying principal substantive tests to the details of accounts at an interim date prior to the balance sheet date, an auditor should: A.

Assess control risk at a low level for the assertions embodied in the accounts selected for interim testing.

B. Determine that the accounts selected for interim testing are not material to the financial statements taken as a whole.

C. Consider whether the amounts of the year-end balances selected for interim testing are reasonably predictable.

D. Obtain written representations from management that all financial records and related data will be made available.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Before performing substantive tests at an interim date, an auditor should consider whether the amounts of the year-end balances selected for interim testing are reasonably predictable with respect to amount, relative significance and composition.

Choice "a" is incorrect. It is not necessary for control risk to be assessed at a low level level for the assertions relating to the accounts that will be substantively tested at an interim date. It may simply be more efficient to perform a substantive audit. As long as the balances tested at interim are reasonably predictable with respect to amount, relative significance and composition, the account may be tested at interim.

Choice "b" is incorrect. Material account balances, such as accounts receivable and inventory, are commonly tested at an interim date. Choice

"d" is incorrect. The written representation letter will not be obtained until after year-end.

QUESTION 210 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.

Correct Answer: B

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Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Control activities are the policies and procedures that help ensure that management directives are carried out. These policies and procedures may relate to any of the three objectives (financial reporting, operations, and compliance), not strictly to the financial reporting objective.

Choice "a" is incorrect. Control activities are defined as the policies and procedures that help ensure that management directives are carried out.

Choice "c" is incorrect. As an auditor obtains an understanding about the other components of internal control, he or she is also likely to obtain some knowledge about control activities. Choice

"d" is incorrect. Ordinarily, audit planning does not require an understanding of control activities related to each account balance, transaction class, and disclosure component.

QUESTION 211

Before applying substantive tests to the details of asset accounts at an interim date, an auditor should assess:

- A. Control risk at a low level.
- B. Inherent risk at a high level.
- C. The difficulty in controlling the incremental audit risk.
- D. Materiality for the accounts tested as insignificant.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Before performing substantive tests at an interim date, the auditor must assess the difficulty in controlling the incremental audit risk from the interim date (on which the substantive procedures are performed) to the yearend date (on which an opinion is rendered).

Choice "a" is incorrect. The auditor would not have to assess control risk at a low level in order to perform substantive tests at interim. It may simply be more efficient to perform a substantive audit. As long as the balances tested at interim are reasonably predictable with respect to amount, relative significance and composition, the account may be tested at interim.

Choice "b" is incorrect. Generally, inherent risk should be low in order to test substantively at interim.

Choice "d" is incorrect. If the materiality level for those accounts to be tested is insignificant, then the auditor probably would not perform any substantive testing, since it is unlikely that a material error exists in an insignificant balance.

QUESTION 212

Which of the following statements best describes how a detailed audit plan of a CPA who is engaged to audit the financial statements of a large publicly held company compares with the audit client's comprehensive internal audit program?

- A. The comprehensive internal audit plan is substantially identical to the audit plan used by the CPA because both cover substantially identical areas.
- B. The comprehensive internal audit plan is less detailed and covers fewer areas than would normally be covered by the CPA.
- C. The comprehensive internal audit plan is more detailed and covers areas that would normally not be covered by the CPA.
- D. The comprehensive internal audit plan is more detailed although it covers fewer areas than would normally be covered by the CPA.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. "Internal auditors" are part of the system of internal control. Their audits would cover more areas in greater depth than those of the "independent auditors," whose concerns are limited to areas materially affecting the "financial statements taken as a whole."

Choices "a", "b", and "d" are incorrect, as described above.

QUESTION 213 When assessing an internal auditor's objectivity, an independent auditor should:

- A. Evaluate the adequacy of the internal auditor's audit plans.
- B. Inquire about the internal auditor's educational background and professional certification.
- C. Consider the organizational level to which the internal auditor reports.
- D. Review the internal auditor's audit documentation.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. When assessing an internal auditor's objectivity, an independent auditor should consider the organizational level to which the internal auditor reports.

Choice "a" is incorrect. Evaluating the adequacy of the internal auditor's audit plans would be performed when assessing an internal auditor's competence.

Choice "b" is incorrect. Inquiring about the internal auditor's educational background and professional certification would be performed when assessing an internal auditor's competence.

Choice "d" is incorrect. Reviewing the internal auditor's audit documentation (to determine the quality of the reports and recommendations) would be performed when assessing an internal auditor's competence.

QUESTION 214

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

- A. Disagreements the predecessor had with the client concerning auditing procedures and accounting principles.

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

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding disagreements the predecessor had with the client concerning auditing procedures and accounting principles.

Choice "b" is incorrect. The successor auditor may make specific inquiries of the predecessor auditor regarding the predecessor's evaluation of matters of continuing accounting significance, but this would occur after accepting the engagement.

Choice "c" is incorrect. The successor auditor may make specific inquiries of the predecessor auditor regarding the degree of cooperation the predecessor received concerning the inquiry of the client's lawyer, but this would occur after accepting the engagement.

Choice "d" is incorrect. The successor auditor would generally come to his or her own conclusions regarding assessments of inherent risk and judgments about materiality without consulting the predecessor auditor.

QUESTION 215

Ordinarily, the predecessor auditor permits the successor auditor to review the predecessor's audit documentation relating to:

	<u>Contingencies</u>	<u>Balance sheet accounts</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D



Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Ordinarily, the predecessor auditor permits the successor auditor to review the predecessor's audit documentation relating to matters of continuing accounting and auditing significance, including both contingencies and balance sheet accounts. Contingencies have continuing significance as they may continue to affect the current year financial statements (either by remaining as contingencies or by being resolved); balance sheet accounts from the prior year-end have continuing significance since they are the opening balances for the current year. Choices "b", "c", and "d" are incorrect, per above explanation.

QUESTION 216

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.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. An engagement letter, which is a presumptively mandatory requirement, sets forth the scope and nature of an auditor's contractual obligation to a client.

Choice "a" is incorrect. A management letter (also known as a letter of recommendations, or a constructive services letter) is usually delivered by the auditor at the end of the audit. It identifies areas of weakness and provides recommended solutions.

Choices "b" and "d" are incorrect. The scope and introductory paragraphs of the auditor's report do provide some information regarding the work performed by the auditor, but they do not express the auditor's understanding with the client as completely as does an engagement letter.

QUESTION 217

An auditor should obtain knowledge of a client's information and communication system in order to understand each of the following, except:

- A. How transactions are initiated, processed, and reported.
- B. The process used to prepare financial statements.
- C. The means used by an entity to communicate financial reporting roles to its staff.
- D. The means used by an entity to ensure that management directives are carried out.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Control activities (not the information and communication system) are the policies and procedures that help ensure that management directives are carried out.

Choices "a", "b", and "c" are incorrect. The auditor obtains an understanding of an entity's information and communication system to understand how transactions are initiated, processed, and reported, the financial reporting process, and the means used by an entity to communicate financial reporting roles and responsibilities.

QUESTION 218 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.



Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Monitoring is the process of assessing the quality of internal control performance over time and taking necessary corrective actions. Eliminating a control that is not operating effectively would not be an appropriate corrective action.

Choice "a" is incorrect. Information derived from external parties (such as customer complaints and regulator comments) may be useful in identifying problems with the internal control structure. Choices "b" and "c" are incorrect. Assessing the quality of internal control performance over time and improving controls that are not operating effectively are part of the monitoring process.

QUESTION 219

In planning an audit of a new client, an auditor most likely would consider the methods used to process accounting information because such methods:

- A. Influence the design of internal control.
- B. Affect the auditor's preliminary judgment about materiality levels.
- C. Assist in evaluating the planned audit objectives.
- D. Determine the auditor's acceptable level of audit risk.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The auditor would consider the methods used to process accounting information in planning an audit of a new client, because such methods influence the design of internal control. The auditor is required to obtain an understanding of the design of internal control in order to plan the audit and determine the nature, timing, and extent of tests to be performed.

Choice "b" is incorrect. The auditor's judgment about materiality levels is based upon the auditor's perception of the needs of a reasonable person who will rely on the financial statements, not on the methods used to process accounting information.

Choice "c" is incorrect. The planned audit objectives are based upon the auditor's desire to render an opinion on the fairness of the financial statements. This end goal is not influenced by the methods used by the client to process accounting information.

Choice "d" is incorrect. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. The auditor's only acceptable level of audit risk is low, and this is not affected by the client's methods used to process accounting information.

QUESTION 220

Dunn, CPA, is auditing the financial statements of Taft Co. Taft uses Quick Service Center (QSC) to process its payroll. Price, CPA, is expressing an opinion on a description of the controls placed in operation at QSC regarding the processing of its customers' payroll transactions. Dunn expects to consider the effects of Price's report on the Taft engagement. Price's report should contain a (an):

- A. Description of the scope and nature of Price's procedures.
- B. Statement that Dunn may assess control risk based on Price's report.
- C. Assertion that Price assumes no responsibility to determine whether QSC's controls are suitably designed.
- D. Opinion on the operating effectiveness of QSC's internal controls.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Price, CPA (the "service auditor") should include in his or her report a description of the scope and nature of the procedures performed.

Choices "b" and "d" are incorrect. A report on controls placed in operation does not provide an opinion on operating effectiveness, and therefore may not be used to assess control risk.

Choice "c" is incorrect. A report on controls placed in operation includes a statement that, "our examination included procedures to obtain reasonable assurance about whether the controls were suitably designed."

QUESTION 221

Payroll Data Co. (PDC) processes payroll transactions for a retailer. Cook, CPA, is engaged to express an opinion on a description of PDC'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 PDC's controls.
- B. State whether PDC's controls were suitably designed to achieve the retailer's objectives.
- C. Identify PDC's controls relevant to specific financial statement assertions.
- D. Disclose Cook's assessed level of control risk for PDC.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. There are two types of reports on the processing of transactions by service organizations: "reports on controls placed in operation" and "reports on controls placed in operation and tests of operating effectiveness." The former do not include tests of operating effectiveness and, therefore, are not intended to provide the user auditor with a basis for reducing the assessment of control risk. Accordingly, such reports should include a disclaimer of opinion regarding the operating effectiveness of the controls.

Choice "b" is incorrect. The report should contain an indication that the controls were suitably designed to achieve specified control objectives, but it does not provide any assurance regarding the achievement of the user organization's (in this case, the retailer's) objectives.

Choice "c" is incorrect. The service auditor (Cook) is not required to identify the service organization's (i.e., PDC's) controls relevant to specific financial statement assertions because this is not a financial statement audit. Choice

"d" is incorrect. The service auditor (Cook) is not required to disclose the assessed level of control risk for the service organization (PDC).

QUESTION 222

Computer Services Company (CSC) processes payroll transactions for schools. Drake, CPA, is engaged to report on CSC's internal controls placed in operation as of a specific date. These internal controls are relevant to the schools' internal control, so Drake's report will be useful in providing the schools' independent auditors with information necessary to plan their audits. Drake's report expressing an opinion on CSC's internal controls placed in operation as of a specific date should contain a(an):

- A. Description of the scope and nature of Drake's procedures.
- B. Statement that CSC's management has disclosed to Drake all design deficiencies of which it is aware.
- C. Opinion on the operating effectiveness of CSC's internal controls.

D. Paragraph indicating the basis for Drake's assessment of control risk.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A report on internal controls for a service organization should include a description of the scope and nature of Drake's procedures.

Choice "b" is incorrect. No statement is made in the report that all design deficiencies have been disclosed. Choice "c" is incorrect. The service auditor's opinion is not intended to provide evidence of operating effectiveness. Choice "d" is incorrect. No paragraph indicating the basis for the assessment of control risk is included in Drake's report.

QUESTION 223

A successor auditor should request the new client to authorize the predecessor auditor to allow a review of the predecessor's:

	<u>Engagement letter</u>	<u>Audit Documentation</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A

B. Option B

C. Option C

D. Option D

Correct Answer: C

Section: Auditing and Attestation

Explanation



Explanation/Reference:

Explanation:

Choice "c" is correct. It is not appropriate for the successor auditor to request a review of the predecessor auditor's engagement letter. This is a business matter between the client and the predecessor auditor that has no impact on the successor's audit. Conversely, review of the predecessor auditor's audit documentation is appropriate and customary to facilitate the successor's audit. Choices "a", "b", and "d" are incorrect, based on the above explanation.

QUESTION 224 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.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

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 225

Lake, CPA, is auditing the financial statements of Gill Co. Gill uses the EDP Service Center, Inc. to process its payroll transactions. EDP's financial statements are audited by Cope, CPA, who recently issued a report on EDP's internal control structure. Lake is considering Cope's report on EDP's internal control structure in assessing control risk on the Gill engagement. What is Lake's responsibility concerning making reference to Cope as a basis, in part, for Lake's own opinion?

- A. Lake may refer to Cope only if Lake is satisfied as to Cope's professional reputation and independence.
- B. Lake may refer to Cope only if Lake relies on Cope's report in restricting the extent of substantive tests.
- C. Lake may refer to Cope only if Lake's report indicates the division of responsibility.
- D. Lake may not refer to Cope under the circumstances above.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The user auditor should not make reference to the report of the service auditor as a basis, in part, for his or her own opinion on the user organization's financial statements. Since the service auditor is not responsible for the examination of any part of the user organization's financial statements, division of responsibility would be inappropriate. Choices "a", "b", and "c" are incorrect, based on the above explanation.

QUESTION 226

Which of the following items does not pertain to the control environment?

- A. Management's philosophy and operating style.
- B. Participation of those charged with governance.
- C. The accounting records.
- D. Personnel policies and practices.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The accounting records pertain to the information and communication system, not to the control environment.

Choices "a", "b", and "d" are incorrect, as management's philosophy and operating style, participation of those charged with governance, and personnel policies and practices are all part of the control environment.

QUESTION 227 On receiving a client's bank cutoff statement, an auditor most likely would trace:

- A. Prior-year checks listed in the cutoff statement to the year-end outstanding checklist.
- B. Deposits in transit listed in the cutoff statement to the year-end bank reconciliation.
- C. Checks dated after year-end listed in the cutoff statement to the year-end outstanding checklist.
- D. Deposits recorded in the cash receipts journal after year-end to the cutoff statement.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The auditor should obtain bank cutoff statements that include transactions for 10 to 15 days after year-end. The outstanding checks and deposits in transit at year-end on the bank reconciliation should agree with the information in the bank cutoff statement.

Choice "b" is incorrect. The deposits in transit are listed in the year-end bank reconciliation and traced to actual deposits appearing on the bank cutoff statement. The cutoff statement includes actual deposits received, not deposits in transit.

Choice "c" is incorrect. Checks dated after year-end would not be included in the year-end outstanding checklist.

Choice "d" is incorrect. Deposits recorded in the cash receipts journal after year-end do not affect the cash balance at year-end, and therefore the auditor would not perform audit procedures with respect to those deposits.

QUESTION 228 Which of the following characteristics most likely would be indicative of check kiting?

- A. High turnover of employees who have access to cash.
- B. Many large checks that are recorded on Mondays.

- C. Low average balance compared to high level of deposits.
- D. Frequent ATM checking account withdrawals.

Correct Answer: C
Section: Auditing and Attestation
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Kiting occurs when a check drawn on one bank is deposited in another bank and no record is made of the disbursement in the balance of the first bank. Frequent kiting may result in a high level of deposits coupled with a low average balance.

Choice "a" is incorrect. High turnover of employees who have access to cash may be normal in certain industries, or it may be indicative of poor hiring policies, but it would not be indicative of check kiting.

Choice "b" is incorrect. More checks may arrive on Mondays simply because Monday's mail includes the mail from over the weekend. This characteristic is not particularly indicative of check kiting. Choice

"d" is incorrect. Frequent ATM checking account withdrawals indicate a frequent need for cash, but this situation is not particularly indicative of check kiting.

QUESTION 229

Which of the following fraudulent activities most likely could be perpetrated due to the lack of effective internal controls in the revenue cycle?

- A. Fictitious transactions may be recorded that cause an understatement of revenues and overstatement of receivables.
- B. Claims received from customers for goods returned may be intentionally recorded in other customers' accounts.
- C. Authorization of credit memos by personnel who receive cash may permit the misappropriation of cash.
- D. The failure to prepare shipping documents may cause an overstatement of inventory balances.

Correct Answer: C
Section: Auditing and Attestation
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The function of cash receipts is part of the treasurer's department and should be separate from the role of posting credits to the A/R ledger. Failure to separate the recordkeeping function from the custodial function allows an individual to misappropriate cash and then cover up the theft by posting credits against the related A/R balance.

Choice "a" is incorrect. If fictitious transactions in the revenue cycle are recorded, then the impact on revenues and receivables would be the same; either both would be overstated (the most likely case) or both would be understated. Choice "b" is incorrect. Even the lack of effective internal controls would not allow this fraud to be perpetrated for long, since the customers that submitted the claim would complain that the credit was not properly applied as soon as they received their next statement or invoice.

Choice "d" is incorrect. The failure to prepare shipping documents may cause inventory to be overstated, but it is unlikely to be perpetrated as a fraud since it does not allow theft of cash. In addition, the internal controls in the revenue cycle typically relate to sales, receivables, and cash, not to inventory.

QUESTION 230

Which of the following internal controls most likely would reduce the risk of diversion of customer receipts by an entity's employees?

- A. A bank lockbox system.
- B. Prenumbered remittance advices.
- C. Monthly bank reconciliations.
- D. Daily deposit of cash receipts.

Correct Answer: A
Section: Auditing and Attestation
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A lockbox system is the best means of preventing defalcation of cash by employees because the employees never have direct access to cash receipts.

Choice "b" is incorrect. The use of prenumbered remittance advices is not effective in preventing theft of receipts by employees because it does not prevent employee access to cash receipts.

Choice "c" is incorrect. While the performance of monthly bank reconciliations is a good control, it would not be effective in preventing the theft of receipts because it does not prevent employee access to cash receipts. (However, it might be effective at detecting a theft that has already occurred).

Choice "d" is incorrect. Daily deposit of cash receipts is not an effective control for preventing theft of receipts by employees because it does not prevent employee access to cash receipts.

QUESTION 231

In testing controls over cash disbursements, an auditor most likely would determine that the person who signs checks also:

- A. Reviews the monthly bank reconciliation.
- B. Returns the checks to accounts payable.
- C. Is denied access to the supporting documents.
- D. Is responsible for mailing the checks.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Once signed, the check should be mailed to the payee by the check signer or an employee operating under the supervision of the check signer to prevent defalcations of checks. Generally this occurs in the treasurer's department.

Choice "a" is incorrect. The check signer would not normally review bank reconciliations.

Choice "b" is incorrect. Accounts payable personnel should not have custody of signed checks since this would constitute a lack of segregation of duties between recording and custody. Choice "c" is incorrect. The check signer should have access to supporting documentation so that it can be reviewed before the check is signed.

QUESTION 232

Which of the following sets of information does an auditor usually confirm on one form?

- A. Accounts payable and purchase commitments.
- B. Cash in bank and collateral for loans.
- C. Inventory on consignment and contingent liabilities.
- D. Accounts receivable and accrued interest receivable.

Correct Answer: B

Section: Auditing and Attestation

Explanation



Explanation/Reference:

Explanation:

Choice "b" is correct. The standard AICPA bank confirmation form includes spaces for the bank to confirm both cash balances on deposit at the bank and collateral pledged on loans originating from the bank.

Choice "a" is incorrect. Purchase commitments are not typically confirmed on an accounts payable confirmation request.

Choice "c" is incorrect. Contingent liabilities (confirmed in a letter of inquiry to the client's attorney or bank) and inventory on consignment (confirmed with the consignee) are not confirmed together. Choice "d" is incorrect. Accrued interest receivable (usually on investments held by a trust company) is not typically confirmed along with trade accounts receivable.

QUESTION 233

The usefulness of the standard bank confirmation request may be limited because the bank employee who completes the form may:

- A. Not believe that the bank is obligated to verify confidential information to a third party.
- B. Sign and return the form without inspecting the accuracy of the client's bank reconciliation.
- C. Not have access to the client's cutoff bank statement.
- D. Be unaware of all the financial relationships that the bank has with the client.

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A bank employee may not have access to all information about transactions with the audit client and thus may be unaware of all the financial relationships the bank has with the client.

Choice "a" is incorrect. Standard bank confirmations contain a signature from an authorized client employee and are a very commonly used audit procedure. It is unlikely that a bank would refuse the request since it has been authorized by the client.

Choice "b" is incorrect. The confirmation is used to verify the bank balance as of year-end. Bank employees generally would not have access to the client's bank reconciliation.

Choice "c" is incorrect. Even though it is likely that the bank would have access to a cutoff bank statement, the detail on this statement is unnecessary to confirm the final balance.

QUESTION 234

Which of the following procedures would an auditor most likely perform in searching for unrecorded liabilities?

- A. Vouch a sample of accounts payable entries recorded just before year-end to the unmatched receiving report file.
- B. Compare a sample of purchase orders issued just after year-end with the year-end accounts payable trial balance.
- C. Vouch a sample of cash disbursements recorded just after year-end to receiving reports and vendor invoices.
- D. Scan the cash disbursements entries recorded just before year-end for indications of unusual transactions.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The auditor is able to detect liabilities not recorded at year-end by comparing cash payments made after the balance sheet date to the related receiving reports and vendor invoices; any payments made on transactions dated before year-end reflect a liability that should have been recorded.

Choice "a" is incorrect. Vouching a sample of recorded accounts payable entries to unmatched receiving reports does not test the completeness of the listing. Unrecorded liabilities would not be included in recorded accounts payable entries.

Choice "b" is incorrect. Purchase orders issued after year-end should not be included in the year-end balance of accounts payable. This would be an example of an overstated liability, rather than an unrecorded one.

Choice "d" is incorrect. Examination of cash disbursements entries made just prior to the balance sheet date relates to liabilities that have been paid, which would not be considered to be outstanding liabilities at year-end.

QUESTION 235

An auditor traced a sample of purchase orders and the related receiving reports to the purchases journal and the cash disbursements journal. The purpose of this substantive audit procedure most likely was to:

- A. Identify unusually large purchases that should be investigated further.
- B. Verify that cash disbursements were for goods actually received.
- C. Determine that purchases were properly recorded.
- D. Test whether payments were for goods actually ordered.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. In general, an audit procedure can be restated as the question to be answered. In this case, tracing a sample of purchase orders and related receiving reports to the purchases journal and the cash disbursements journal seeks to answer the question, "Were all purchases properly recorded?" (the completeness assertion).

Choice "a" is incorrect. Tracing a sample of source documents to summary records would not identify unusually large transactions requiring additional attention.

Choice "b" is incorrect. In order to verify that cash disbursements were for goods actually received, a sample of cash disbursements should be vouched back to receiving reports. Choice "d" is incorrect. In order to verify that cash disbursements were for goods actually ordered, a sample of cash disbursements should be vouched back to purchase orders.

QUESTION 236

Sound internal control dictates that, immediately upon receiving checks from customers by mail, a responsible employee should:

- A. Add the checks to the daily cash summary.
- B. Verify that each check is supported by a prenumbered sales invoice.
- C. Prepare a duplicate listing of checks received.
- D. Record the checks in the cash receipts journal.

Correct Answer: C

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Upon receipt of cash, a remittance listing should be prepared.

Choice "a" is incorrect. Recording the check in the daily cash summary would ordinarily be done by a second party after the initial listing has been prepared.

Choice "b" is incorrect. Verifying that each check is supported by a valid invoice is not necessary.

Choice "d" is incorrect. Recording the check in the cash receipts journal would ordinarily be done by a second party after the initial listing has been prepared.

QUESTION 237 To provide assurance that each voucher is submitted and paid only once, an auditor most likely would examine a sample of paid vouchers and determine whether each voucher is:

- A. Supported by a vendor's invoice.
- B. Stamped "paid" by the check signer.
- C. Prenumbered and accounted for.
- D. Approved for authorized purchases.

Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. By stamping the voucher "paid," the check signer cancels the voucher so it cannot be resubmitted for payment.

Choice "a" is incorrect. Even invoices that are supported by prenumbered sales invoices can be resubmitted for payment if they are not canceled, resulting in duplicate payments.

Choice "c" is incorrect. Accounting for the sequence of prenumbered vouchers would only test whether all vouchers are present. It would not prevent a voucher from being paid twice. Choice

"d" is incorrect. Proper authorization would help ensure that payments were properly authorized, but would not prevent duplicate payments.

QUESTION 238

B.
Proper authorization of write-offs of uncollectible accounts should be approved in which of the following departments? A.

Accounts receivable.

- Credit.
- C. Accounts payable.
- D. Treasurer.

Correct Answer: D
Section: Auditing and Attestation
Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The treasurer does not perform duties that are incompatible with authorizing writeoffs since he or she is usually not involved with sales transactions or recordkeeping.

Choice "a" is incorrect. Recording accounts receivable and authorizing write-offs would constitute an improper segregation of duties.

Choice "b" is incorrect. Granting credit and authorizing write-offs represents an improper segregation of duties since non-existent customers could have credit authorized and then have their accounts written off. Choice "c" is incorrect. The accounts payable department is typically involved in the expenditure cycle, not the revenue cycle.

QUESTION 239

Which of the following procedures most likely would not be an internal control designed to reduce the risk of errors in the billing process?

- A. Comparing control totals for shipping documents with corresponding totals for sales invoices.
- B. Using computer programmed controls on the pricing and mathematical accuracy of sales invoices.
- C. Matching shipping documents with approved sales orders before invoice preparation.
- D. Reconciling the control totals for sales invoices with the accounts receivable subsidiary ledger.

Correct Answer: D
Section: Auditing and Attestation
Explanation



Explanation/Reference:

Explanation:

Choice "d" is correct. Reconciling control totals for sales invoices with the accounts receivable subsidiary ledger is not an effective control related to the billing process, since errors that exist in the preparation of invoices would likely carry through to accounts receivable.

Choice "a" is incorrect. Comparing shipping totals with sales invoice totals is an effective control to reduce billing errors.

Choice "b" is incorrect. Computer controls related to pricing and mathematical accuracy will reduce billing errors.

Choice "c" is incorrect. Matching shipping documents with approved sales orders ensures that invoices are properly authorized and only goods ordered have been shipped.

QUESTION 240 In assessing control risk for purchases, an auditor vouches a sample of entries in the voucher register to the supporting documents. Which assertion would this test of controls most likely support?

- A. Completeness.
- B. Occurrence.
- C. Accuracy.
- D. Rights and obligations.

Correct Answer: B
Section: Auditing and Attestation
Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Vouching to supporting documents tests the occurrence assertion.

Choice "a" is incorrect. Tracing from supporting documentation to the voucher register would support the completeness assertion.

C.
Choice "c" is incorrect. The accuracy assertion would be tested by examining the details of the supporting documents. Choice "d" is incorrect. The rights and obligations assertion does not relate to transactions and events.

QUESTION 241

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

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

Correct Answer: D

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Accounting for unused prenumbered purchase orders and receiving reports is an effective control, but it would not typically be performed in the vouchers payable department. Choice "a" is incorrect. Reconciling the vendor invoice with the related receiving report is typically performed by a vouchers payable clerk. Choice "b" is incorrect. The vouchers payable department is responsible for approving vouchers for payment. Choice "c" is incorrect. Indicating the asset and expense accounts to be debited is not an internal control procedure.

QUESTION 242

Which of the following tests of controls most likely would help assure an auditor that goods shipped are properly billed?

- A. Scan the sales journal for sequential and unusual entries.
- B. Examine shipping documents for matching sales invoices.
- C. Compare the accounts receivable ledger to daily sales summaries.
- D. Inspect unused sales invoices for consecutive prenumbering.



Correct Answer: B

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Tracing from a sample of shipping documents to matching sales invoices would provide support for the completeness assertion for billing. Choice "a" is incorrect. Scanning the sales journal for sequential and unusual entries tests the completeness and existence assertions for sales, but would not provide assurance that shipped goods were properly billed. Choice "c" is incorrect. Comparing the accounts receivable ledger to the daily sales summary helps ensure that all sales were recorded as receivables and all receivables were recorded as sales, but it does not provide assurance that shipped goods were properly billed. Choice "d" is incorrect. Inspecting the consecutive numbering of unused sales invoices might identify fictitious sales, but it would not ensure that goods that have been shipped were properly billed.

QUESTION 243 An auditor's purpose in reviewing credit ratings of customers with delinquent accounts receivable most likely is to obtain evidence concerning management's assertions about:

- A. Valuation and allocation.
- B. Understandability and classification.
- C. Existence.
- D. Rights and obligations.

Correct Answer: A

Section: Auditing and Attestation

Explanation

Explanation/Reference:

Explanation:

D.

Choice "a" is correct. Assertions about valuation and allocation deal with whether asset, liability, revenue, and expense components have been included in the financial statements at appropriate amounts, and any resulting valuation adjustments are appropriately recorded. For example, management asserts that trade accounts receivable included in the balance sheet are stated at net realizable value.

Choice "b" is incorrect. Assertions about understandability and classification deal with whether financial information is appropriately presented and described, and disclosures are clearly expressed. Reviewing credit ratings of delinquent customers does not provide evidence about this type of assertion.

Choice "c" is incorrect. Assertions about existence deal with whether assets, liabilities, and equity interest of the entity exist at a given date. Reviewing credit ratings of delinquent customers does not provide evidence about this type of assertion.

Choice "d" is incorrect. Assertions about rights and obligations deal with whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. Reviewing credit ratings of delinquent customers does not provide evidence about this type of assertion.

QUESTION 244

Which of the following audit procedures would an auditor most likely perform to test controls relating to management's assertion concerning the completeness of sales transactions?



- A. Verify that extensions and footings on the entity's sales invoices and monthly customer statements have been recomputed.
- B. Inspect the entity's reports of prenumbered shipping documents that have not been recorded in the sales journal.
- C. Compare the invoiced prices on prenumbered sales invoices to the entity's authorized price list.
- D. Inquire about the entity's credit granting policies and the consistent application of credit checks.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Examination of reports of shipments not recorded in the sales journal is an appropriate test of controls to determine whether all sales have been recorded.

Choice "a" is incorrect. Verification that extensions and footings on sales invoices and statements have been recomputed by client personnel ensures that independent checks are being performed, but does not address whether all sales transactions have been recorded.

Choice "c" is incorrect. Comparison of invoiced prices with the client's authorized price list ensures that the prices charged are authorized, but does not address whether all sales transactions have been recorded. Choice "d" is incorrect. Inquiring about credit policies is an appropriate audit procedure to verify authorization and valuation of sales transactions, not completeness.

QUESTION 245

Which of the following internal controls most likely would assure that all billed sales are correctly posted to the accounts receivable ledger?

- A. Daily sales summaries are compared to daily postings to the accounts receivable ledger.
- B. Each sales invoice is supported by a prenumbered shipping document.
- C. The accounts receivable ledger is reconciled daily to the control account in the general ledger.
- D. Each shipment on credit is supported by a prenumbered sales invoice.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Comparison of daily sales summaries to daily postings to the accounts receivable ledger would ensure the completeness of the accounts receivable ledger.

Choice "b" is incorrect. Comparison of sales invoices to shipping documents verifies occurrence of the sale, not completeness of the accounts receivable ledger.

Choice "c" is incorrect. Reconciliation of the accounts receivable ledger to the general ledger would not assure the accuracy and completeness of the accounts receivable ledger because a sale which was improperly excluded from receivables would likely be omitted from both ledgers.

Choice "d" is incorrect. Ensuring that all shipments are billed verifies completeness of sales transactions, but does not provide evidence that all sales are recorded in the accounts receivable ledger. In other words, the fact that a shipment was billed does not mean that the invoice was also recorded in the accounts receivable ledger.

QUESTION 246

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.

Correct Answer: B

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Matching vendor's invoices with receiving reports provides authorization for payment and is generally performed in the accounts payable department. Recalculation of vendor invoices is compatible with this authorization function.

Choice "a" is incorrect. Posting the accounts payable records (recording) is incompatible with matching (authorization). Generally these functions would be performed by two different employees.

Choice "c" is incorrect. This review procedure (independent verification) should be performed by someone independent of the employee who approved the invoice for payment. Choice

"d" is incorrect. Payment and cancellation of vendor invoices should be performed by someone (generally the treasurer) other than the individual authorizing payment.

QUESTION 247

To determine whether internal control relative to the revenue cycle of a wholesaling entity is operating effectively in minimizing the failure to prepare sales invoices, an auditor most likely would select a sample of transactions from the population represented by the:

- A. Sales order file.
- B. Customer order file.
- C. Shipping document file.
- D. Sales invoice file.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Shipping documents provide evidence that a sale occurred, and therefore selecting from a population of shipping documents allows the auditor to test whether corresponding invoices exist for each sale. Choices "a" and "b" are incorrect. The existence of customer orders and sales orders does not necessarily imply that a sale occurred. For example, the particular item requested may be out of stock.

In such cases, there would properly be no sales invoice.

Choice "d" is incorrect. Since the weakness the auditor is concerned about involves missing sales invoices, selecting from a sample of existing sales invoices would not identify this problem.

QUESTION 248

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.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

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 249 An auditor who uses a transaction cycle approach to assessing control risk most likely would test control activities related to transactions involving the sale of goods to customers with the:

- A. Collection of receivables.
- B. Purchase of merchandise inventory.
- C. Payment of accounts payable.
- D. Sale of long-term debt.

Correct Answer: A

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The revenue cycle includes sales, receivables, and cash receipts, so an auditor using a transaction cycle approach would be likely to test sales and receivables together.

Choice "b" is incorrect. Purchases are part of the expenditures cycle while sales are part of the revenue cycle, so an auditor using a transaction cycle approach would be unlikely to test these items together.

Choice "c" is incorrect. Payables are part of the expenditures cycle while sales are part of the revenue cycle, so an auditor using a transaction cycle approach would be unlikely to test these items together.

Choice "d" is incorrect. Sale of long-term debt falls within the "other liabilities" transaction cycle while sales are part of the revenue cycle, so an auditor using a transaction cycle approach would be unlikely to test these items together.

QUESTION 250

Tracing copies of computer-prepared sales invoices to copies of the corresponding computer-prepared shipping documents provides evidence that:

- A. Shipments to customers were properly billed.
- B. Entries in the accounts receivable subsidiary ledger were for sales actually shipped.

- C. Sales billed to customers were actually shipped.
- D. No duplicate shipments to customers were made.

Correct Answer: C

Section: Auditing and Attestation Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Tracing from invoices to shipping documents would provide evidence that sales billed to customers were actually shipped. An invoice for which the corresponding shipping documents could not be located might be indicative of fictitious sales (i.e., sales that were recorded but never actually shipped).

Choice "a" is incorrect. The auditor would need to start with shipping documents and trace to invoices to ensure that shipments were properly billed.

Choice "b" is incorrect. An invoice may exist for which no entry was made in the accounts receivable subsidiary ledger. Therefore, the auditor would need to trace from entries in the accounts receivable subsidiary ledger (and not from invoices) to shipping documents, to obtain evidence that recorded receivables were for sales actually shipped.

Choice "d" is incorrect. Tracing from invoices to shipping documents would not necessarily indicate when a duplicate shipment was made, as the auditor would not necessarily realize that two sets of shipping documents related to the same invoice.

QUESTION 251

Fanny and John each own and manage their own companies. Fanny's business is manufacturing freight boxes of all types, and John's business is selling freight boxes to different industries. They decide to combine their expertise and knowledge to produce and sell freight boxes specifically designed for the new airline company that just formed in their city. Which of the following best describes the business formed by the parties?

- A. A general partnership.
- B. A limited liability partnership.
- C. A sole proprietorship.
- D. A joint venture.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A joint venture is formed for a single business undertaking such as building and designing freight containers to be sold specifically to one company. Each company coming together in this joint venture has its own business outside of this one endeavor.

Choice "a" is incorrect. A general partnership is more broad in its business purpose than a joint venture is.

Choice "b" is incorrect. A limited liability partnership is primarily designed for professionals who want to work as partners but with limited personal liability. Choice

"c" is incorrect. Sole proprietorships have only one person in the business.

QUESTION 252 A sole proprietorship would be an ideal form of business to select if:

- A. The individual desired no liability beyond his capital investment.
- B. The individual wanted to be able sell the business at will.
- C. The individual wanted the business to be a separate entity from the sole proprietor.
- D. The individual wanted the business to continue indefinitely.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A sole proprietor is free to transfer or sell the business at will.

Choice "a" is incorrect because a sole proprietor is personally liable for all obligations of the business.

Choice "c" is incorrect. A sole proprietorship is not considered an entity separate from the sole proprietor. Choice

"d" is incorrect because a sole proprietorship ends with the death of the sole proprietor.

QUESTION 253

Formation of which of the following types of business does not require the filing of documents with the state?

<u>Corporation</u>	<u>Limited Partnership</u>	<u>Sole Proprietorship</u>
A. Need not file	Need not file	Need not file
B. Need not file	Must file	Need not file
C. Must file	Must file	Need not file
D. Must file	Need not file	Must file

- A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A sole proprietorship can be formed without filing with the state. Formation of either a corporation or a limited partnership requires a filing. Choices "a", "b", and "d" are incorrect per the Explanation: above.

QUESTION 254

Which of the following forms of business can be formed with only one individual owning the business?

	<u>Sole Proprietorship</u>	<u>Limited Liability Company</u>	<u>Partnership</u>
A.	Yes	Yes	Yes
B.	Yes	Yes	No
C.	Yes	No	Yes
D.	No	No	No

- A. Option A
B. Option B
C. Option C
D. Option D

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A sole proprietorship and (in most states) a limited liability company can be formed with only one owner. A partnership requires two or more partners. Choices "a", "c", and "d" are incorrect per the explanation above.

QUESTION 255

Noll Corp. and Orr Corp. are contemplating entering into an unincorporated joint venture. Such a joint venture:

- A. Will be treated as a partnership in most important legal respects.
B. Must be dissolved upon the completion of a single undertaking.
C. Will be treated as an association for federal income tax purposes and taxed at the prevailing corporate rates.

D. Must file a certificate of limited partnership with the appropriate state agency.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The legal requirements, the consequences, the advantages, and disadvantages of forming a joint venture generally are identical to those of a general partnership. Joint ventures are treated as a partnership in most important legal aspects.

Choice "b" is incorrect. A joint venture need not be dissolved upon the completion of a single undertaking. Joint ventures may be formed for a single transaction or for a related series of transactions. Choice "c" is incorrect because a joint venture would be taxed like a partnership, not a corporation.

Choice "d" is incorrect because a joint venture, like a partnership, may be formed without filing with the state.

QUESTION 256 What term is used to describe a partnership without a specified duration?

- A. A perpetual partnership.
- B. A partnership by estoppel.
- C. An indefinite partnership.
- D. A partnership at will.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A partnership at will is a partnership with no definite term (i.e., without specified duration). Such a partnership can be terminated at any time.

Choice "a" is incorrect. A partnership without a specified duration is called a partnership at will, not a perpetual partnership. There is no such thing as a perpetual partnership because a partnership is not perpetual. A partnership may be dissolved after a partner dies or otherwise dissociates from the partnership.

Choice "b" is incorrect. A partnership by estoppel is the appearance of a partnership when there is no formal partnership. If parties who are not partners give the appearance to third parties that they are partners, the law may deem the parties to be a partnership by estoppel. The parties will be treated as partners, even though they are not.

Choice "c" is incorrect. The legal term for a partnership of indefinite duration is a partnership at will, not an indefinite partnership.

QUESTION 257 A general partnership must:

- A. Pay federal income tax.
- B. Have two or more partners.
- C. Have written articles of partnership.
- D. Provide for apportionment of liability for partnership debts.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A partnership is an organization of two or more persons who carry on a business for a profit.

Choice "a" is incorrect. Partnerships do not pay federal income taxes; the partners report their shares of the partnership's income on their individual returns.

Choice "c" is incorrect. A partnership agreement need not be in writing.

Choice "d" is incorrect. If the partnership agreement is silent on the apportionment of liability for partnership debts, state law or the Uniform Partnership Act will cover the omission.

QUESTION 258

When a partner in a general partnership lacks actual or apparent authority to contract on behalf of the partnership, and the party contracted with is aware of this fact, the partnership will be bound by the contract if the other partners:

	<u>Ratify the contract</u>	<u>Amend the partnership agreement</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. "Yes - No."

Rule: The authority of partners is governed by agency law. Under agency law, a principal is not bound to the third party unless the agent had actual authority or apparent authority. When the agent has no actual authority and no apparent authority, the principal (in this case the partnership) will only be liable if it chooses to adopt the agreement (i.e., ratify).

Rule: Amending the partnership agreement (presumably to grant authority) will not cause the partnership to be bound because authority must exist at the time the contract is made or the partnership must ratify the contract. Choices "a", "c", and "d" are incorrect, per the above rules.

QUESTION 259

On February 1, Addison, Bradley, and Carter, physicians, formed ABC Medical Partnership. Dr. Bradley was placed in charge of the partnership's financial books and records. On April 1, Dr. Addison joined the City Hospital Medical Partnership, retaining the partnership interest in ABC. On May 1, ABC received a writ of attachment from the court attaching Dr. Carter's interest in ABC. The writ resulted from Dr. Carter's failure to pay a credit card bill. On June 1, Dr. Addison was adjudicated bankrupt. On July 1, Dr. Bradley was sued by the other partners of ABC for an accounting of ABC's revenues and expenses.

Under the Revised Uniform Partnership Act, which of the preceding events resulted in the dissociation of a partner?

- A. Dr. Addison joining the City Hospital Medical Partnership.
- B. Dr. Carter's interest in the partnership being attached by the court.
- C. Dr. Addison being adjudicated bankrupt.
- D. Dr. Bradley being sued for an accounting by the other partners of ABC.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The bankruptcy of a partner will result in the dissociation of a partner.

Choice "a" is incorrect, because although joining the city hospital medical partnership could be construed as a breach of fiduciary duty owed to the other partners in ABC medical partnership, standing alone, it would not result in a dissociation.

Choice "b" is incorrect. All that was attached was the partner's right to distributions, which does not cause dissociation.

Choice "d" is incorrect, because although being sued might cause Dr. Bradley to resign, which would cause dissociation, standing alone, being sued by the other partners does not cause dissociation.

QUESTION 260

When parties intend to create a partnership that will be recognized under the Revised Uniform Partnership Act, they must agree to:

	<u>Conduct a business for profit</u>	<u>Share gross receipts from a business</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. "Yes - No."

Rule: A partnership is an agreement between two or more persons to carry on, as co-owners, a business for profit; partners share management and profits and losses, not gross receipts.

Choices "a", "c", and "d" are incorrect, per the above rule.

QUESTION 261

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.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Because the agreement is silent as to duration, it is a partnership at will. A partner may dissociate from a partnership at will at any time.

Choice "b" is incorrect. Because the agreement is silent as to duration, it is a partnership at will. A partner may dissociate from a partnership at will at any time. No court order is required.

Choice "c" is incorrect. Partnerships are consensual relationships, so any partner has the power to dissociate at any time; he or she need not obtain the consent of the other partners (though absent consent, the partner will be liable for damages if the dissociation is wrongful).

Choice "d" is incorrect. There is no requirement of giving partnership creditors a formal notice of intent to dissociate, but it is a good idea to do so to avoid liability on future partnership obligations.

QUESTION 262

The partners of College Assoc., a general partnership, decided to dissolve the partnership and agreed that none of the partners would continue to use the partnership name. Under the Revised Uniform Partnership Act, which of the following events will occur on dissolution of the partnership?

	<i>Each partner's existing liability would be discharged</i>	<i>Each partner's apparent authority would continue</i>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. "No - Yes."

Rule: Upon the dissolution of the partnership, each of the partners continues to have liability for partnership debts. Upon dissolution of the partnership each of the partners will continue to have apparent authority. The apparent authority of a partner can only be negated upon proper notice to third parties. Choices "a", "b", and "d" are incorrect, per the above rule.

QUESTION 263 Which of the following requirements must be met to have a valid partnership exist?

- I. Co-ownership of all property used in a business.
- II. Co-ownership of a business for profit.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct.

Rule: A partnership is defined as an association of two or more persons who agree to carry on as coowners a business for profit. Thus, II is necessary. However, there is no requirement that all property used in the business be co-owned; it may be owned by individual partners. Thus I is not necessary. Choices "a", "c", and "d" are incorrect, per the above rule.

QUESTION 264

Locke and Vorst were general partners in a kitchen equipment business. On behalf of the partnership, Locke contracted to purchase 15 stoves from Gage. Unknown to Gage, Locke was not authorized by the partnership agreement to make such contracts. Vorst refused to allow the partnership to accept delivery of the stoves and Gage sought to enforce the contract. Gage will:

- A. Lose, because Locke's action was not authorized by the partnership agreement.
- B. Lose, because Locke was not an agent of the partnership.
- C. Win, because Locke had express authority to bind the partnership.
- D. Win, because Locke had apparent authority to bind the partnership.

Correct Answer: D

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Every partner is an agent of the partnership and has apparent authority to bind the partnership to contracts that appear to carry on in the usual way the business of the partnership. It would be usual for a partner in a kitchen equipment business to have authority to purchase stoves. Thus, Gage will win because of Locke's apparent authority.

Choice "a" is incorrect. Every partner is an agent for his partnership and has apparent authority to bind the partnership to contracts that appear to carry on in the usual way the business of the partnership.

Choice "b" is incorrect. Every partner is an agent of the partnership.

Choice "c" is incorrect. Locke did not have express authority to purchase the stoves. The facts state that Locke was not authorized to purchase the stoves and thus lacked express authority.

QUESTION 265

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.

Correct Answer: C

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. All partners have apparent authority to enter into transactions apparently within the regular scope of the partnership business. No such authority exists, however, for transactions outside the regular scope of business. The sale of a business's goodwill is extraordinary and is outside the ordinary scope of business. Thus, a partner must get authorization from all other partners to make the sale.

Choice "a" is incorrect. All partners have apparent authority to enter into transactions apparently within the regular scope of the partnership business. Purchasing inventory is within the regular scope of business, so a partner need not get permission from the other partners to bind the partnership.

Choice "b" is incorrect. All partners have apparent authority to enter into transactions apparently within the regular scope of the partnership business. Hiring employees is within the regular scope of a business, so a partner need not get permission from the other partners to bind the partnership.

Choice "d" is incorrect. All partners have apparent authority to enter into transactions apparently within the regular scope of the partnership business. Entering into advertising contracts is within the regular course of business, and so a partner need not get permission from the other partners to bind the partnership.

QUESTION 266 On dissolution of a general partnership, distributions will be made on account of:

- I. Partners' capital accounts.
- II. Amounts owed partners with respect to profits.
- III. Amounts owed partners for loans to the partnership.

In the following order:

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

Correct Answer: A

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct.

Rule: On dissolution of a general partnership the "order of distribution" would be as follows:

- III. General partner loans.
- I. Partners' capital accounts.

II. General partners' profits.

Choices "b", "c", and "d" are incorrect, per the above rule.

QUESTION 267 Which of the following is not necessary to create an express partnership?

- A. Execution of a written partnership agreement.
- B. Agreement to share ownership of the partnership.
- C. Intention to conduct a business for profit.
- D. Intention to create a relationship recognized as a partnership.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A written partnership agreement, while certainly desirable, is not usually necessary to form a valid partnership; partnership agreements are not normally subject to the statute of frauds.

Choice "b" is incorrect. A partnership is an association of two or more persons who agree to carry on as co-owners of a business for profit. Thus, an agreement to share ownership of the partnership is a requirement for creating an express partnership.

Choice "c" is incorrect. A partnership is an association of two or more persons who agree to carry on as co-owners of a business for profit. Thus, an intent to carry on a business for a profit is a requirement for creating an express partnership.

Choice "d" is incorrect. A partnership is an association of two or more persons who agree to carry on as co-owners of a business for profit. The intent to create a business relationship recognized as a partnership is a requirement for creating an express partnership.

QUESTION 268

Eller, Fort, and Owens do business as Venture Associates, a general partnership. Trent Corp. brought a breach of contract suit against Venture and Eller individually. Trent won the suit and filed a judgment against both Venture and Eller.

Trent will generally be able to collect the judgment from:

- A. Partnership assets only.
- B. The personal assets of Eller, Fort, and Owens only.
- C. Eller's personal assets only after partnership assets are exhausted.
- D. Eller's personal assets only.



Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. When a judgment is obtained against both a partnership and an individual general partner, the plaintiff must proceed against the partnership assets first and then the assets of any individual general partner. The partnership assets must be exhausted before any general partner's individual assets can be attached. Choices "a", "b", and "d" are incorrect, per the above rule.

QUESTION 269

Heather, Erika, and Shelby are members in HES LLC. Heather works 40 hours per week and Erika and Shelby work 20 hours per week. Heather contributed \$30,000 to the LLC and Erika and Shelby contributed \$60,000 each. Erika and Shelby have each originated 45% of the LLC's business and Heather has originated the other 10%.

If HES were a general partnership, who controls management?

- A. Heather, because she works the most.
- B. Erika and Shelby equally because they contributed the most.
- C. Heather, Erika, and Shelby equally because of state law.
- D. Erika and Shelby, because they originate most of the work.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct.

Rule: Absent an agreement to the contrary, partners have equal management authority. Choices "a", "b", and "d" are incorrect, per the above rule.

QUESTION 270

Rivers and Lee want to form a partnership. For the partnership agreement to be enforceable, it must be in writing if:

- A. Rivers and Lee reside in different states.
- B. The agreement cannot be completed within one year from the date on which it will be entered into.
- C. Either Rivers or Lee is to contribute more than \$500 in capital.
- D. The partnership intends to buy and sell real estate.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A transaction which cannot be completed within a year must be in writing to be enforceable.

Choice "a" is incorrect. Residence of the prospective partners is not relevant.

Choice "c" is incorrect. The statute of frauds \$500 threshold applies to the sale of goods only.

Choice "d" is incorrect. Transactions in land are within the statute of frauds, but the possibility that a partnership may engage in a real estate transaction is not a transaction in land.

QUESTION 271 Which of the following statements is correct regarding the division of profits in a general partnership when the written partnership agreement only provides that losses be divided equally among the partners?

Profits are to be divided:

- A. Based on the partners' ratio of contribution to the partnership.
- B. Based on the partners' participation in day-to-day management.
- C. Equally among the partners.
- D. Proportionately among the partners.



Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct.

Rule: When the partnership agreement is silent as to how profits are to be divided, they are divided equally. Note also that when the agreement is silent, losses are treated similar to profits, there is no reverse rule that profits are treated like losses.

Choices "a", "b", and "d" are incorrect, per the above rule.

QUESTION 272

Downs, Frey, and Vick formed the DFV general partnership to act as manufacturers' representatives. The partners agreed Downs would receive 40% of any partnership profits and Frey and Vick would each receive 30% of such profits. It was also agreed that the partnership would not terminate for five years.

After the fourth year, the partners agreed to terminate the partnership. At that time, the partners' capital accounts were as follows: Downs, \$20,000; Frey, \$15,000; and Vick, \$10,000. There also were undistributed losses of \$30,000.

Which of the following statements about the form of the DFV partnership agreement is correct?

- A. It must be in writing because the partnership was to last for longer than one year.
- B. It must be in writing because partnership profits would not be equally divided.
- C. It could be oral because the partners had explicitly agreed to do business together.
- D. It could be oral because the partnership did not deal in real estate.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Under the statute of frauds, an agreement, which by its terms cannot be performed within a year, must be evidenced by a writing containing the material terms and signed by the parties to be charged. Absent a writing, the partnership will be treated as a partnership at will.

Choice "b" is incorrect. There is no requirement that partnership agreements be in writing merely because profits will be divided unequally.

Choice "c" is incorrect. The statute of frauds requires contracts that cannot by their terms be performed within one year to be evidenced by a writing containing the material terms and signed by the parties to be charged. Choice

"d" is incorrect. Whether or not a partnership is to deal in real estate is irrelevant to whether the partnership agreement must be in writing.

QUESTION 273

Downs, Frey, and Vick formed the DFV general partnership to act as manufacturers' representatives.

The partners agreed Downs would receive 40% of any partnership profits and Frey and Vick would each receive 30% of such profits. It was also agreed that the partnership would not terminate for five years.

After the fourth year, the partners agreed to terminate the partnership. At that time, the partners' capital accounts were as follows: Downs, \$20,000; Frey, \$15,000; and Vick, \$10,000. There also were undistributed losses of \$30,000. Vick's share of the undistributed losses will be:

- A. \$0
- B. \$1,000
- C. \$9,000
- D. \$10,000

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Rule: Where the partnership agreement is silent, losses are shared in the same proportion as profits.

Choice "c" is correct. Vick was entitled to 30% of the profits and so will be responsible for 30% of the undistributed \$30,000 loss, or \$9,000. Choices

"a", "b", and "d" are incorrect, per the above rule.

QUESTION 274

Lewis, Clark, and Beal entered into a written agreement to form a partnership. The agreement required that the partners make the following capital contributions: Lewis, \$40,000, Clark, \$30,000, and Beal, \$10,000. It was also agreed that in the event the partnership experienced losses in excess of available capital, Beal would contribute additional capital to the extent of the losses. The partnership agreement was otherwise silent about division of profits and losses. Which of the following statements is correct?

- A. Profits are to be divided among the partners in proportion to their relative capital contributions.
- B. Profits are to be divided equally among the partners.
- C. Losses will be allocated in a manner different from the allocation of profits because the partners contributed different amounts of capital.
- D. Beal's obligation to contribute additional capital would have an effect on the allocation of profit or loss to Beal.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct.

Rule: Regardless of the contributions and obligations of the partners, unless the partnership agreement specifically states otherwise, all partners are entitled to an equal share of the profits. Choices

"a", "c", and "d" are incorrect, per the above rule.

QUESTION 275

Gillie, Taft, and Dall are partners in an architectural firm. The partnership agreement is silent about the payment of salaries and the division of profits and losses. Gillie works full-time in the firm, and Taft and Dall each work half time. Taft invested \$120,000 in the firm, and Gillie and Dall invested \$60,000 each. Dall is responsible for bringing in 50% of the business, and Gillie and Taft 25% each. How should profits of \$120,000 for the year be divided?

- A. Gillie \$60,000, Taft \$30,000, Dall \$30,000. B. Gillie \$40,000, Taft \$40,000, Dall \$40,000. C. Gillie \$30,000, Taft \$60,000, Dall \$30,000.
- D. Gillie \$30,000, Taft \$30,000, Dall \$60,000.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. \$40,000 – \$40,000 – \$40,000 (equally).

Rule: In the absence of an agreement to the contrary, the profits will be shared equally regardless of investment of money or time. Choices

"a", "c", and "d" are incorrect, per the above rule.

QUESTION 276

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

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

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

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

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

Choice "c" is incorrect. A partner may assign his interest in the partnership at any time without consent of the partners since such an assignment does not make the assignee a partner; instead it merely gives the assignee the assignor's rights to distributions from the partnership.

Choice "d" is incorrect. A sale of partnership good will is an extraordinary transaction that requires consent of the partners. A single partner has no authority to make such a sale on his own accord.

QUESTION 277

Which of the following statements is correct concerning liability when a partner in a general partnership commits a tort while engaged in partnership business?

- A. The partner committing the tort is the only party liable.
- B. The partnership is the only party liable.
- C. Each partner is jointly and severally liable.
- D. Each partner is liable to pay an equal share of any judgment.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Each partner is jointly and severally liable for torts committed by any partner while in the course of partnership business.

Choice "a" is incorrect. All partners may be held liable for a tort committed by a partner in the course of partnership business.

Choice "b" is incorrect. Each partner is liable for torts committed by any partner while in the course of partnership business.

Choice "d" is incorrect. Each partner is liable for the full amount of damages incurred as a result of a partner's tort; the partners are not liable only for their pro rata share.

QUESTION 278

Lark, a partner in DSJ, a general partnership, wishes to withdraw from the partnership and sell Lark's interest to Ward. All of the other partners in DSJ have agreed to admit Ward as a partner and to hold Lark harmless for the past, present, and future liabilities of DSJ. As a result of Lark's withdrawal and Ward's admission to the partnership, Ward:

- A. Acquired only the right to receive Ward's share of DSJ profits.
- B. Has the right to participate in DSJ's management.
- C. Is personally liable for partnership liabilities arising before and after being admitted as a partner.
- D. Must contribute cash or property to DSJ to be admitted with the same rights as the other partners.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The general rule is that the mere assignment of a partner's interest does not make the assignee a partner. One may become a partner only with the consent of all other partners. Here, all other partner's consented to Ward's becoming a partner. Thus, Ward is a partner with full rights to participate in management.

Choice "a" is incorrect. The general rule is that the mere assignment of a partner's interest does not make the assignee a partner. One may become a partner only with the consent of all other partners.

Here, all other partner's consented to Ward's becoming a partner. Thus, Ward is a partner with full partner rights.

Choice "c" is incorrect. An incoming partner is not liable for debts that the partnership incurred before admission beyond the incoming partner's contribution, but is fully liable for debts incurred after becoming a partner. Choice

"d" is incorrect. A partnership is a consensual relationship; there is no requirement of a contribution to become a partner.

QUESTION 279

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

	<i>Partnership property</i>	<i>Partnership distributions</i>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D



Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct.

Rules: A partner has no right to assign an interest in partnership property because a partner's rights in partnership property are limited to using the property for partnership purposes. However, a partner does have a right to assign her interest in partnership distributions. The assignee does not become a partner, but merely has a right to receive whatever distributions the assignor would have received. Choices "a", "b", and "d" are incorrect, per the above rules.

QUESTION 280

Cobb, Inc., a partner in TLC Partnership, assigns its partnership interest to Bean, who is not made a partner. After the assignment, Bean asserts the rights to:

- I. Participate in the management of TLC.
 - II. Cobb's share of TLC's partnership profits.
- Bean is correct as to which of these rights?

- A. I only.
- B. II only.
- C. I and II.
- D. Neither I nor II.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct.

Rule: The assignee of a partner's interest in the partnership does not thereby become a partner absent the unanimous consent of the other partners. Thus, the assignee has no right to participate in the management of the partnership and has only a right to receive the assignor's share of the partnership profits. Choices "a", "c", and "d" are incorrect, per the above rules.

QUESTION 281

A partner's interest in specific partnership property is:

	<i>Assignable to the partner's individual creditors</i>	<i>Subject to attachment by the partner's individual creditors</i>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. No - No.

Rule: A partner's interest in specific partnership property is neither assignable to the partner's individual creditors nor is it subject to attachment by the partner's individual creditors. Choices "a", "b", and "c" are incorrect, per the above rule.

QUESTION 282

If no provisions are made in an agreement, a general partnership allocates profits and losses based on the:

- A. Value of actual contributions made by each partner.
- B. Number of partners.
- C. Number of hours each partner worked in the partnership during the year.
- D. Number of years each partner belonged to the partnership.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Absent an agreement to the contrary, all partners have equal rights to share in the profits of the partnership. Choices "a", "c", and "d" are incorrect, per the above explanation.

QUESTION 283

Under the Uniform Partnership Act, which of the following statements is(are) correct regarding the effect of the assignment of an interest in a general partnership?

- I. The assignee is personally responsible for the assigning partner's share of past and future partnership debts.
- II. The assignee is entitled to the assigning partner's interest in partnership profits and surplus on dissolution of the partnership.

- A. I only.
- B. II only.

- C. Both I and II.
D. Neither I nor II.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A partner may assign his or her interest in the partnership. The effect of such an assignment is to transfer the partner's right to receive the partner's share of profits or surplus only. Such an assignment does not cause dissolution or make the assignee a new partner. The assignor is still regarded as a partner and is liable for past and future partnership debts. The assignee, since he is not a partner, is not liable for past and future partnership debts. Choice "a" is incorrect. The assignee of an interest in a general partnership is not personally responsible for the assigning partner's share of past and future partnership debts but is entitled to the assigning partner's interest in partnership profits and surplus on dissolution of the partnership.

Choice "c" is incorrect. The assignee of an interest in a general partnership is entitled to the assigning partner's interest in partnership profits and surplus on dissolution of the partnership but is not personally responsible for the assigning partner's share of past and future partnership debts.

Choice "d" is incorrect. The assignee of an interest in a general partnership is entitled to the assigning partner's interest in partnership profits and surplus on dissolution of the partnership but is not personally responsible for the assigning partner's share of past and future partnership debts.

QUESTION 284

Smith and James were partners in S and J Partnership. The partnership agreement stated that all profits and losses were allocated 60 percent to Smith and 40 percent to James. The partners decided to terminate and wind up the partnership. The following was the balance sheet for S and J on the day of the windup:

Cash	\$40,000
Accounts receivable	12,000
Property and equipment	<u>38,000</u>
Total assets	<u>\$90,000</u>
Accounts payable	\$24,000
Smith, capital	30,000
James, capital	<u>36,000</u>
Total liabilities and capital	<u>\$90,000</u>



Of the total accounts receivable, \$10,000 was collected and the remainder was written off as bad debt. All liabilities of S and J were paid by the partnership. The property and equipment are sold for \$32,000. Under the Uniform Partnership Act, what amount of cash was distributed to Smith?

- A. \$25,200
B. \$26,000
C. \$30,000
D. \$34,800

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Upon termination of the partnership creditors are paid first. After payment of creditors, each partner is deemed to have an account that is charged or credited an amount equal to the partner's contribution plus or minus the partner's share of any profits or losses.

The agreement between Smith and James was that profits and losses would be allocated 60% to Smith and 40% to James. The partnership had \$82,000 in assets (\$40,000 in cash, \$10,000 from accounts receivable, and \$32,000 from property and equipment). The partnership had \$90,000 in liabilities and capital. Of the \$82,000 in assets, \$24,000 is paid first to creditors. This leaves a balance of \$58,000.

Smith contributed \$30,000 in capital and James contributed \$36,000 in capital. With \$66,000 owed in capital and only \$58,000 available, there is a deficit of \$8,000. By agreement, Smith is responsible for 60% of the \$8,000 deficit or \$4,800. Smith would be credited an amount equal to his capital (\$30,000) minus his share of the loss (\$4,800) or \$25,200. Only choice "a" reflects this amount. Choices "b", "c", and "d" are incorrect, per the above calculation.

QUESTION 285

Leslie, Kelly, and Blair wanted to form a business. Which of the following business entities does not require the filing of organization documents with the state?

- A. Limited partnership.
- B. Joint venture.
- C. Limited liability company.
- D. Subchapter S corporation.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A joint venture is like a partnership. A partnership or joint venture can be formed without filing any documents with the state.

Choice "a" is incorrect. Formation of a limited partnership requires the filing of a certificate of limited partnership with the state.

Choice "c" is incorrect. A limited liability company may be formed only by filing articles of organization with the state.

Choice "d" is incorrect. A corporation, including a Subchapter S corporation, may be formed only by filing articles of incorporation with the state.

QUESTION 286

Under the Revised Uniform Partnership Act, which of the following have the right to inspect partnership books and records?

- A. Employees.
- B. Former partners.
- C. Inactive partners.
- D. Transferees of partners' interests.

Correct Answer: C

Section: Business Environment and Concept

Explanation



Explanation/Reference:

Explanation:

Choice "c" is correct. Every partner in a partnership - whether active or inactive - has the right to inspect the partnership's books and records.

Choice "a" is incorrect. Only a partner has a right to inspect the partnership's books and records; an employee of the partnership has no such right.

Choice "b" is incorrect. Only current partners have a right to inspect the partnership's books and records; former partners do not have such a right.

Choice "d" is incorrect. Only partners have a right to inspect a partnership's books and records. A transferee of a partner's interest has only the partner's right to distributions.

QUESTION 287

Berry, Drake, and Flanigan are partners in a general partnership. The partners made capital contributions as follows: Berry, \$150,000; Drake, \$100,000; and Flanigan, \$50,000. Drake made a loan of \$50,000 to the partnership. The partnership agreement specifies that Flanigan will receive a 50% share of profits, and Drake and Berry each will receive a 25% share of profits. Under the Revised Uniform Partnership Act and in the absence of any partnership agreement to the contrary, which of the following statements is correct regarding the sharing of losses?

- A. The partners will share equally in any partnership losses.
- B. The partners will share in losses on a pro rata basis according to the capital contributions.
- C. The partners will share in losses on a pro rata basis according to the capital contributions and loans made to the partnership.
- D. The partners will share in losses according to the allocation of profits specified in the partnership agreement.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Under the Revised Uniform Partnership Act, unless agreed otherwise, partners share losses in the same manner that they share profits.

Choice "a" is incorrect. Under the Revised Uniform Partnership Act, unless agreed otherwise, partners share losses in the same manner that they share profits. Here, the partners agreed to share profits in a 2:1:1 ratio. Thus, losses will be shared in that manner rather than equally.

Choice "b" is incorrect. Under the Revised Uniform Partnership Act, unless agreed otherwise, partners share losses in the same manner that they share profits. They are not shared in accordance with the partners' capital contributions.

Choice "c" is incorrect. Under the Revised Uniform Partnership Act, unless agreed otherwise, partners share losses in the same manner that they share profits. They are not shared in accordance with the partners' capital contributions or loans.

QUESTION 288

Fil and Breed are 50% partners in F&B Cars, a used-car dealership. F&B maintains an average used-car inventory worth \$150,000. On January 5, National Bank obtained a \$30,000 judgement against Fil and Fil's child on a loan that Fil had cosigned and on which Fil's child had defaulted. National sued F&B to be allowed to attach \$30,000 worth of cars as part of Fil's interest in F&B's inventory. Will National prevail in its suit?

- A. No, because the judgement was not against the partnership.
- B. No, because attachment of the cars would dissolve the partnership by operation of law.
- C. Yes, because National had a valid judgement against Fil.
- D. Yes, because Fil's interest in the partnership inventory is an asset owned by Fil.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A partner has no right to possess partnership property except for partnership purposes. Thus, a personal creditor of a partner has no right to attach items of partnership property to satisfy a partner's personal debt.

Choice "b" is incorrect. There is no such rule. If the partnership were liable for the individual partner's debt, the cars could be attached and the partnership would not be dissolved.

Choice "c" is incorrect. A partner has no right to possess partnership property except for partnership purposes. Thus, a personal creditor of a partner has no right to attach items of partnership property to satisfy a partner's personal debt.

Choice "d" is incorrect. A partner has no right to possess partnership property except for partnership purposes. Thus, a personal creditor of a partner has no right to attach items of partnership property to satisfy a partner's personal debt.

QUESTION 289

Sam, CPA, is one of the partners in a limited liability partnership with other CPAs. Sam avoids personal liability for:

- A. The wrongful acts of employees acting under his supervision.
- B. His own negligent acts.
- C. The malpractice of his partners regarding errors and omissions.
- D. The negligent actions of his subordinates under his direct control.



Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct.

Rule: A partner in a LLP is personally liable for tort liabilities arising from his own negligence and the negligence of his direct subordinates and for breach of contract damages. He is NOT personally liable for the negligent actions committed by his partners.

Choices "a", "b", and "d" are incorrect, per the above rule.

QUESTION 290 A limited liability

partnership must:

- A. File registration documents with the state in which it is formed.
- B. Hold all partners personally liable for all debts and liabilities of the partnership and partners.
- C. Carry no less than one hundred thousand dollars of property insurance.
- D. Not have partners with professional licenses.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct.

Rule: To have limited liability, an LLP must file with the state a registration statement usually referred to as Articles of LLP. It is generally designed for professionals who desire to be partners with other like professionals and yet not have liability for the malpractice of their partners. Some states require that personal liability insurance (not property insurance) be carried to protect those harmed by the professionals' malpractice. Choices "b", "c", and "d" are incorrect, per the above rule.

QUESTION 291

Jones, Smith, and Bay wanted to form a company called JSB Co. but were unsure about which type of entity would be most beneficial based on their concerns. They all desired the opportunity to make taxfree contributions and distributions where appropriate. They wanted earnings to accumulate tax-free.

They did not want to be subject to personal holding tax and did not want double taxation of income. Bay was going to be the only individual giving management advice to the company and wanted to be a member of JSB through his current company, Channel, InC. Which of the following would be the most appropriate business structure to meet all of their concerns?

- A. Proprietorship.
- B. S corporation.
- C. C corporation.
- D. Limited liability partnership.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. An LLP does not pay taxes on its earnings. Instead, the profits and losses flow through to the partners as in a general partnership. The LLP files an informational tax return like that of a general partnership. The partners may agree to have the entity managed by one or more of the partners.

A partner may be another entity.

Choice "a" is incorrect. A proprietorship by definition has only one owner, not three owners.

Choice "b" is incorrect. While an S corporation allows for the same treatment of its earnings and distributions as in the facts, it is prohibited from having another company as an owner.

Choice "c" is incorrect. A C corporation pays its own taxes on its earnings, and any distributions to its shareholders are again taxed at the shareholder level (known as "double taxation").

QUESTION 292

Which of the following partners of a limited liability partnership (LLP) may avoid personal liability when a partner commits a negligent act?

- A. All the partners.
- B. The supervisor of the negligent partner.
- C. All the partners other than the negligent partner.
- D. All the partners other than the supervisor of, and, the negligent partner.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. LLP partners are liable only for their own negligence and the negligence of anyone who commits a wrongful act under the partner's direct control. Choices "a", "b", and "c" are incorrect, per the above.

QUESTION 293 Green Trees, LP is a limited partnership. Dave is a limited partner. Seeds Today, InC. is a creditor of the limited partnership. Upon dissolution of the partnership, the assets of Green Trees, LP will be distributed to pay:

- A. Seeds Today, Inc., first.
- B. Dave first.
- C. Seeds Today, Inc. and Dave.
- D. The general partners first.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct.

Rule: Upon dissolution, the assets of a limited partnership are first used to pay off the outside creditors. Limited partners such as Dave are next in line.

Choices "b", "c", and "d" are incorrect, per the above rule.

QUESTION 294 A limited partnership must have:

- A. One general partner and two limited partners.
- B. All must be general partners and one limited partner.
- C. One general partner and one limited partner.
- D. All limited partners.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct.

Rule: A limited partnership must have at least one general partner and one limited partner.

Choices "a", "b", and "d" are incorrect, per the above rule. Be careful of answers that include the word "all."

QUESTION 295

Juan is a limited partner in Pet Food and Fun, Limited Partnership. Juan visited Chow, Inc., a local supplier of dog food claiming to be a "partner" in the partnership and negotiated a distribution contract between the supplier and limited partnership on behalf of the partnership. As a result of these actions, Juan:

- A. Has limited liability as a limited partner in reference to all creditors.
- B. Has limited liability as a limited partner to all creditors except Chow, Inc.
- C. Has full personal liability to all creditors.
- D. None of the above.



Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct.

Rule: A limited partner will be considered a general partner with full personal liability only to those that the limited partner transacts with as if he were a general partner. Limited partners have no right to participate in management, such as negotiating contracts on behalf of the limited partnership. The limited partner will retain his status and limited liability to all others that the limited partner has not transacted with on behalf of the partnership. Choices "a", "c", and "d" are incorrect, per the above rule.

QUESTION 296

Doug was the sole general partner in Heavy Foot, Limited Partnership. While driving to work one morning, Doug died in a car accident. The limited partnership:

- A. Continues to exist as it was before Doug's death.
- B. Dissolves by operation of law as a result of Doug's death.
- C. Dissolves only by attaining a judicial decree.
- D. Converts to a general partnership and all former limited partners become general partners.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct.

Rule: The death of a general partner will by operation of law, dissolve the limited partnership. Because the dissolution is by operation of law, there is no requirement to attain a judicial decree. Remaining limited partners do not automatically become general partners as a result of the death of the general partner. Choices "a", "c", and "d" are incorrect, per the above rule.

QUESTION 297

Which of the following statements is correct with respect to the differences and similarities between a corporation and a limited partnership?

- A. Stockholders may be entitled to vote on corporate matters but limited partners are prohibited from voting on any partnership matters.
- B. Stock of a corporation may be subject to the registration requirements of the federal securities laws but limited partnership interests are automatically exempt from those requirements.
- C. Directors owe fiduciary duties to the corporation and limited partners owe such duties to the partnership.
- D. A corporation and a limited partnership may be created only under a state statute and each must file a copy of its organizational document with the proper governmental body.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Both a limited partnership and a corporation:

1. Can only be created by statute, and
2. Each must file a copy of its certificate with the proper state agency.

Choice "a" is incorrect. There are instances in which limited partners do vote on certain partnership matters (e.g., approve new general or limited partners).

Choice "b" is incorrect. Limited partnership interests are not automatically exempt from the federal securities laws. Choice "c" is incorrect. Limited partners do not owe a fiduciary duty to the limited partnership.

QUESTION 298

Aarons Group, 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.



Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct.

Rule: Partners in a limited partnership can agree as to how they will split profits and losses, with losses shared up to the amount of the limited partners' capital. Profits and losses are shared on the basis of percentages of capital contributions only in the absence of an agreement otherwise.

Choices "a", "c", and "d" are incorrect, per the above rule.

QUESTION 299 Lisa is a limited partner in a limited partnership. Jen, one of the other limited partners, is seeking to sell her interest in the partnership to Karen and allow Karen to become a new limited partner. Which of the following statements is true?

- A. Lisa may engage in the management of the limited partnership without losing her limited liability.
- B. Jen may transfer her interest and make Karen a new limited partner without the approval of the other partners.
- C. Jen may withdraw from the limited partnership without giving notice to the partnership.
- D. Lisa has a right to vote on the transferring of interest to and admission of Karen as a limited partner.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Limited partners have the right to vote on the transfer of interest and admission of a new partner. Admission of a new partner requires unanimous consent.

Choice "a" is incorrect. A limited partner who acts as a general partner loses her limited liability status to those she acted as a general partner towards.

Choice "b" is incorrect. Partners can freely transfer their interests in profits and losses to third parties, but the third party cannot become a limited partner without the unanimous consent of the other partners. Choice "c" is incorrect. Limited partners must give 6 months notice of withdrawal in absence of an agreement to the contrary.

QUESTION 300 Which of the following statements is correct with respect to a limited partnership?

- A. A limited partner may not be an unsecured creditor of the limited partnership.
- B. A general partner may not also be a limited partner at the same time.
- C. A general partner may be a secured creditor of the limited partnership.
- D. A limited partnership can be formed with limited liability for all partners.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. In a limited partnership, a general partner may be a secured creditor of the limited partnership.

Choice "a" is incorrect. In a limited partnership, a limited partner may be an unsecured creditor of the limited partnership.

Choice "b" is incorrect. In a limited partnership, a general partner may also be a limited partner at the same time.

Choice "d" is incorrect. In a limited partnership, only the limited partners will have limited liability. A limited partnership must have at least one general partner and general partners have unlimited liability. The word "all" makes this option wrong.

QUESTION 301 In general, which of the following statements is correct with respect to a limited partnership?

- A. A limited partner has the right to obtain from the general partner(s) financial information and tax returns of the limited partnership.
- B. A limited partnership can be formed with limited liability for all partners.
- C. A limited partner may not also be a general partner at the same time.
- D. A limited partner may hire employees on behalf of the partnership.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A limited partner has rights similar to those of a corporate shareholder; he must be allowed to review financial and tax information of the limited partnership.

Choice "b" is incorrect. A limited partnership must have one or more general partners, whose liability is unlimited.

Choice "c" is incorrect. One may be both a general and a limited partner simultaneously. Such a person has all of the rights and liabilities of both a limited partner and a general partner. Choice "d" is incorrect. A limited partner has no management authority, rather he is a passive investor, like a corporate shareholder.

QUESTION 302 In general, which of the following statements is correct with respect to a limited partnership?

- A. A limited partner will be personally liable for partnership debts incurred in the ordinary course of the partnership's business.
- B. A limited partner is unable to participate in the management of the partnership in the same manner as general partners and still retain limited liability.
- C. A limited partner's death or incompetency will cause the partnership to dissolve.
- D. A limited partner is an agent of the partnership and has the authority to bind the partnership to contracts.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. While the general rule is that a limited partner has no liability on partnership debts except to the extent of his agreed-upon contribution, the limited partner will lose this limited liability if he takes part in control of the business, which generally means a limited partner may not manage the business on a day-to-day basis as a general partner could.

Choice "a" is incorrect. Limited partners are not personally liable for partnership debts; their liability generally is limited to their contributions.

Choice "c" is incorrect. Death or incapacity of a general partner will cause a dissolution, but the same is not true of a limited partner.

Choice "d" is incorrect. A limited partner is more like a shareholder in a corporation than like a general partner. Limited partners are not agents of their partnerships and have no authority to bind their partnership on contracts.

QUESTION 303

White, Grey, and Fox formed a limited partnership. White is the general partner and Grey and Fox are the limited partners. Each agreed to contribute \$200,000. Grey and Fox each contributed \$200,000 in cash while White contributed \$150,000 in cash and \$50,000 worth of services already rendered. After two years, the partnership is insolvent. The fair market value of the assets of the partnership is \$150,000 and the liabilities total \$275,000. The partners have made no withdrawals.

If Fox is insolvent and White and Grey each has a net worth in excess of \$300,000, what is White's maximum potential liability in the event of a dissolution of the partnership?

- A. \$62,500
- B. \$112,500C. \$125,000
- D. \$175,000

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Rule: The liability of a limited partner for partnership debts is limited to the extent of the capital, which he has contributed or has agreed to contribute. A general partner, however, is liable for all partnership debts and liabilities.

Choice "c" is correct. In this case, both Grey and Fox are limited partners and, thus, their respective maximum liability for partnership debts may not exceed their contributions (\$200,000 each). Because White is a general partner, however, he will be personally liable for the excess of any debt remaining after assets have been applied upon a dissolution. Therefore, White will be liable for \$125,000 (the difference between the fair market value of assets (\$150,000) and partnership liabilities (\$275,000) at dissolution).

Choices "a", "b", and "d" are incorrect, per the above rule.

QUESTION 304

Harry, Betty, and Jim decide to form a hair salon business. Betty and Jim agree to equally manage the business and have agreed to accept full personal liability for obligations of the business. Harry contributes money to help them get started. Harry does not want any personal liability but does want access to the books and records and to share in the profits. They have all agreed that unanimous consent is needed to transfer their ownership interests. Assume any necessary filings have been made.

What type of business entity best reflects the terms of their agreement? The three have formed:

- A. A limited partnership.
- B. A limited liability company.
- C. A general partnership.
- D. A corporation.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A limited partnership best reflects the terms of the parties' agreement. A limited partnership has one or more general partners and one or more limited partners. The general partners are personally liable for partnership obligations and run the business (such as Betty and Jim agreed). A limited partner does not have personal liability for partnership obligations and does not take part in management; however, limited partners have a right to inspect partnership books and records relevant to their interest. Thus, a limited partnership has the attributes that Harry agreed to. Finally, all partners must unanimously consent to a transfer of an ownership interest in a limited partnership, as the parties agreed here. Thus, a limited partnership best reflects the agreement of the parties.

Choice "b" is incorrect. Members of a limited liability company are not personally liable for the company's debt. (They may agree otherwise, but this is not a general attribute of a limited liability company.) Because the facts say Betty and Jim each agreed to have full personal liability, a limited liability company does not best reflect the parties' agreement.

Choice "c" is incorrect. All partners are personally liable for all obligations of a general partnership. Because the facts say Harry did not accept personal liability, the agreement does not reflect a general partnership.

Choice "d" is incorrect. Corporate shareholders generally are not liable for the corporation's obligations. (They may agree otherwise, but this is not a basic attribute of a corporation.) As the facts say Betty and Jim share full personal liability, the agreement does not reflect a corporation.

QUESTION 305

White, Grey, and Fox formed a limited partnership. White is the general partner and Grey and Fox are the limited partners. Each agreed to contribute \$200,000. Grey and Fox each contributed \$200,000 in cash while White contributed \$150,000 in cash and \$50,000 worth of services already rendered. After two years, the partnership is insolvent. The fair market value of the assets of the partnership is \$150,000 and the liabilities total \$275,000. The partners have made no withdrawals.

Unless otherwise provided in the certificate of limited partnership, which of the following is correct if Fox assigns her interest in the partnership to Barr and only White consents to Barr's admission as a limited partner?

- A. Barr will not become a substituted limited partner unless Grey also consents.
- B. Barr will have the right to inspect the partnership's books.
- C. The partnership will be dissolved.
- D. Barr will become a substituted limited partner because White, as general partner, consented.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. In the absence of an agreement between all partners, the assignment of a partner's interest does not make the assignee a substitute partner; it merely transfers the assignor's rights to distributions to the assignee. Choice "b" is incorrect. Absent an agreement among the partners otherwise, an assignment of an interest in a partnership is merely an assignment of the assignor's rights to receive distributions from the partnership and does not give the assignee any right to inspect the partnership's books.

Choice "c" is incorrect. Absent an agreement among the partners otherwise, an assignment of an interest in a partnership is merely an assignment of the assignor's rights to receive distributions from the partnership; it does not make the assignee a new partner. Since there is no change in who is a partner, there is no dissolution.

Choice "d" is incorrect. All partners must agree to make someone a partner, not just the general partner.

QUESTION 306 Under the Revised Uniform Limited Partnership Act and in the absence of a contrary agreement by the partners, which of the following events is most likely to dissolve a limited partnership?

- A. A majority vote in favor by the partners.
- B. A two-thirds vote in favor by the partners.
- C. A withdrawal of a majority of the limited partners.
- D. Withdrawal of the only general partner.



Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Absent a contrary agreement of the partners, a limited partnership can be dissolved by written consent of all the general partners, withdrawal or death of a general partner, or judicial decree. Thus, withdrawal of the only general partner would cause dissolution. (There has to be at least one general partner in a limited partnership.) Choice "a" is incorrect. It takes unanimous written consent of all general partners to dissolve the limited partnership, not majority vote.

Choice "b" is incorrect. It takes unanimous written consent of all general partners to dissolve the limited partnership, not two-thirds vote.

Choice "c" is incorrect. Death or withdrawal of a limited partner does not cause dissolution. Only death or withdrawal of a general partner causes dissolution.

QUESTION 307

Eller, Fort and Owens are members of Venture Associates, LLC. Trent Corp. brought a breach of contract suit against Venture for a contract executed by Eller as an agent of the LLC. If Trent prevails, Trent will generally be able to collect the judgment from:

- A. The LLC's assets only.
- B. The personal assets of Eller, Fort and Owens jointly.
- C. Eller's personal assets only after LLC assets are exhausted.
- D. Eller's personal assets only.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct.

Rule: Members of an LLC are not personally liable for the LLC's obligations. Moreover, an agent is not liable on a contract the agent enters into on behalf of a disclosed principal. Here, the contract was entered into by Eller on behalf of Venture, an LLC, and Eller disclosed that he was acting only as an agent of Venture. Thus, Trent Corp. can collect from the LLC'S assets only. Choices "b", "c", and "d" are incorrect, per the above rule.

QUESTION 308

Tim, Peter, and Rick want to form a limited liability company. What document must they file with the state?

- A. Operating Agreement.
- B. Articles of Incorporation.
- C. Bylaws.
- D. Articles of Organization.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The Articles of Organization must be filed with the secretary of state.

Choice "a" is incorrect. An operating agreement is an agreement between the members containing provisions relating to management, profit sharing, transferring interests, etc. and does not need to be filed with the state. Choices "b" and "c" are incorrect. Articles of incorporation and bylaws are documents relating to corporations, and they are not required to be filed with the state.

QUESTION 309

The articles of organization for a limited liability company must contain everything, except the following:

- A. The name of the entity that includes some indication it is a LLC.
- B. The name and address of the registered agent.
- C. Number of shares authorized and issued.
- D. If the company is to be manager managed, a statement to that effect.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Limited liability companies do not issue "shares" held by shareholders like in a corporation. Instead, members (the owners) are said to have "interests" in the LLC. Choices "a", "b", and "d" are incorrect. These are all required to be included in the articles of organization.

QUESTION 310

Unless there is an agreement to the contrary, the voting power of members in a limited liability company is determined by:

- A. Each member's salary.
- B. Each member's share of profits.
- C. When the member was admitted to the company.
- D. Each member's capital contribution.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct.

Rule: Absent an agreement otherwise, all members generally participate in management, and their voting strength is determined in proportion to ownership interest. This is calculated by comparing each member's capital contribution to that of the other members.

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

QUESTION 311



Heather, Erika, and Shelby are members in HES LLC. Heather works 40 hours per week and Erika and Shelby work 20 hours per week. Heather contributed \$30,000 to the LLC and Erika and Shelby contributed \$60,000 each. Erika and Shelby have each originated 45% of the LLC's business and Heather has originated the other 10%. Absent an agreement to the contrary among the owners, who controls the management of the HES LLC? A. Heather, because she works the most.

- B. Erika and Shelby equally because they contributed the most.
- C. Heather, Erika, and Shelby in proportion to their ownership interests.
- D. Erika and Shelby, because they originate most of the work.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct.

Rule: Absent an agreement to the contrary, the members' voting strength is proportionate to their contributions. Choices

"a", "b", and "d" are incorrect, per the above rule.

QUESTION 312

Heather, Erika, and Shelby are members in HES 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.

Correct Answer: C

Section: Business Environment and Concept

Explanation



Explanation/Reference:

Explanation:

Choice "c" is correct. Absent an agreement to the contrary, if a member of an LLC dies, the LLC is dissolved unless the other members consent to continue. Choice

"a" is incorrect, because the LLC does not have to dissolve upon the death of a member.

Choice "b" is incorrect, because the LLC does not cease to exist immediately.

Choice "d" is incorrect, because the LLC does not continue unless the members consent to continue.

QUESTION 313

Heather, Erika, and Shelby are members in HES LLC. Heather works 40 hours per week and Erika and Shelby work 20 hours per week. Heather contributed \$30,000 to the LLC and Erika and Shelby contributed \$60,000 each. Erika and Shelby have each originated 45% of the LLC's business and Heather has originated the other 10%. Absent an agreement to the contrary, how will the LLC's \$120,000 profits be divided among the members?

	<u>Heather</u>	<u>Erika</u>	<u>Shelby</u>
A.	\$60,000	\$30,000	\$30,000
B.	\$40,000	\$40,000	\$40,000
C.	\$12,000	\$54,000	\$54,000
D.	\$24,000	\$48,000	\$48,000

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Rule: Absent an agreement to the contrary, the LLC's profits will be divided among the members in proportion to their contributions. Here, Heather's, Erika's and Shelby's contributions were \$30,000, \$60,000, and \$60,000, respectively. Thus, the profits will be divided in a 1:2:2 ratio (20% of \$120,000 to Heather; 40% of \$120,000 to Erika; and \$120,000 to Shelby). Choice "d" is correct.

Heather Erika Shelby
D. \$24,000 \$48,000 \$48,000

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

QUESTION 314 A member of a limited liability company may generally do all of the following, except:

- A. Transfer his membership in the company without the consent of the other members.
- B. Participate in the management of the company absent an agreement to the contrary.
- C. Have limited liability.
- D. Order office supplies for the company.

Correct Answer: A

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The transfer of a member interest requires the consent of the other members. Members may not assign their interest without the other members' consent.

Choice "b" is incorrect. Unless the members have agreed to operate as a manager managed limited liability company, all members have the power to participate in management.

Choice "c" is incorrect. Members in a limited liability company all have limited personal liability. Choice "d" is incorrect. Unless otherwise agreed, members have the right to manage the everyday operations of a limited liability company. This can include the ordering of office supplies.

QUESTION 315

Jeb, a member in J & S LLC, sold his interest in the LLC to Chris without obtaining the other members' consent. Absent an agreement to the contrary, Chris:

- I. May participate in the management of J & S.
 - II. May receive Jeb's share of J & S's profits.
 - III. Is not entitled to anything since Jeb did not obtain the other members' consent.
-
- A. I only.
 - B. I and II only.
 - C. II only.
 - D. III only.

Correct Answer: C

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Absent an agreement to the contrary, if a member in the LLC sells his interest in an LLC without obtaining the other members' consent, the assignee is only entitled to receive the assignor's share of profits.

Choices "a", "b", and "d" are incorrect, because, absent an agreement to the contrary, although a member of an LLC is allowed to assign his interest in profits and losses, an assignee of a membership interest may not participate in the management of the LLC.

QUESTION 316 Which of the following parties generally has the most management rights?

- A. Minority shareholder in a corporation listed on a national stock exchange.
- B. Limited partner in a general partnership.
- C. Member of a limited liability company.
- D. Limited partner in a limited partnership.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Unless the articles or operating agreement provides otherwise, all members of the LLC have a right to participate in management. A member of a limited liability company has the most management rights of any of the parties listed. A minority shareholder in a corporation has no management rights (and neither does a majority shareholder). A limited partner has no day-to-day management rights but may have some rights in extraordinary circumstances. It is unclear what a limited partner in a general partnership would even be; the existence of a limited partner would make a partnership a limited partnership and not a general partnership.

Choice "a" is incorrect. Stockholders have very limited rights to run the corporation. They generally only have the right to elect directors and to vote on fundamental changes in the corporation. Such fundamental changes would include dissolutions, amendments to the articles, mergers, consolidations, compulsory share exchanges, and sale of substantially all of the corporation's assets.

Choice "b" is incorrect. There are no limited partners in a general partnership. There are only general partners. Since there are no limited partners, there are no management rights for limited partners.

Choice "d" is incorrect. Limited partners in a limited partnership have very limited rights to participate in the management of the business. In fact, if they do participate in management, they face potential liability to those who thought they were a general partner (i.e., if a limited partner becomes involved in day-to-day management in some way (participating in control), she may be treated as a general partner and lose her limited liability).

QUESTION 317 Case Corp. is incorporated in State A. Under the Revised Model Business Corporation Act, which of the following activities engaged in by Case requires that Case obtain a certificate of authority to do business in State B?

- A. Maintaining bank accounts in State B.
- B. Collecting corporate debts in State B.
- C. Hiring employees who are residents of state B.
- D. Maintaining an office in State B to conduct intrastate business.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A domestic corporation is one created under the laws of a given state. A foreign corporation is a corporation created under the laws of another state. A foreign corporation must obtain a certificate of authority from each state in which it does intrastate business.

Choices "a", "b", and "c" are incorrect because maintaining a bank account, collecting debts, and hiring employees who live within a state are not considered to be "doing business" within the state.

QUESTION 318

Which of the following statements is(are) correct regarding the methods a target corporation may use to ward off a takeover attempt?

- I. The target corporation may make an offer ("self-tender") to acquire stock from its own shareholders.
 - II. The target corporation may seek an injunction against the acquiring corporation on the grounds that the attempted takeover violates federal antitrust law.
- A. I only.
 - B. II only.
 - C. Both I and II.
 - D. Neither I nor II.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct.

Rule: A tender offer is a general invitation by a bidder to the shareholders of a target company to tender their shares to the bidder at a specified price during a specified time. A target of a takeover may ward off a tender offer by offering to repurchase shares from its shareholders. If a takeover will violate federal antitrust law, a court will enjoin the takeover. Choices "a", "b", and "d" are incorrect, per the above rule.

QUESTION 319

Acorn Corp. wants to acquire the entire business of Trend Corp. Which of the following methods of business combination will best satisfy Acorn's objectives without requiring the approval of the shareholders of either corporation?

- A. A merger of Trend into Acorn, whereby Trend shareholders receive cash or Acorn shares.

- B. A sale of all the assets of Trend, outside the regular course of business, to Acorn, for cash.
- C. An acquisition of all the shares of Trend through a compulsory share exchange for Acorn shares.
- D. A cash tender offer, whereby Acorn acquires at least 90% of Trend's shares, followed by a short-form merger of Trend into Acorn.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A parent corporation owning 90% or more of a subsidiary may merge the subsidiary (short form merger) into the parent without the approval of the shareholders of either corporation or the approval of the subsidiary's board.

Choices "a", "b", and "c" all require at least one of the corporations to follow the general procedure for fundamental corporate changes (i.e., board resolution notice, approval by majority shares, and filing).

QUESTION 320

Under the Revised Model Business Corporation Act, which of the following statements regarding a corporation's bylaws is(are) correct?

- I. A corporation's initial bylaws shall be adopted by either the incorporators or the board of directors.
- II. A corporation's bylaws are contained in the articles of incorporation.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Under the Revised Model Business Corporation act, a corporation's initial bylaws may be adopted by either the incorporators or the board of directors.

Choices "b" and "c" are incorrect, because the corporation's bylaws are a separate document not included in the corporation's articles of incorporation.

Choice "d" is incorrect, because under the Revised Model Business Corporation Act, a corporation's initial bylaws may be adopted by either the incorporators or the board of directors.

QUESTION 321

Under the Revised Model Business Corporation Act, which of the following must be contained in a corporation's articles of incorporation?

- A. Quorum voting requirements.
- B. Names of stockholders.
- C. Provisions for issuance of par and nonpar shares.
- D. The number of shares the corporation is authorized to issue.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The articles must set out the corporation's authorized shares.

Choice "a" is incorrect. Quorum requirements, if stated at all, usually are in the bylaws; they need not be included in the articles of incorporation.

Choice "b" is incorrect. The articles need not include the names of stockholders.

Choice "c" is incorrect. The RMBCA has eliminated the concept of par value and so does not have a requirement that par value be established in the articles.

QUESTION 322

Under the Revised Model Business Corporation Act, a merger of two public corporations usually requires all of the following, except:

- A. A formal plan of merger.

- B. An affirmative vote by the holders of a majority of each corporation's voting shares.
- C. Receipt of voting stock by all stockholders of the original corporations.
- D. Approval by the board of directors of each corporation.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A merger can be effected by giving some parties cash or property; not everyone need receive voting shares.

Choice "a" is incorrect. The merger must be pursuant to a formal plan.

Choice "b" is incorrect. The majority of each corporation generally must approve a merger.

Choice "d" is incorrect. A plan of merger must be approved by the boards of the merging corporations.

QUESTION 323

Which of the following provisions must a for-profit corporation include in its articles of incorporation to obtain a corporate charter?

- I. Provision for the authorization of voting stock. II.
Name of the corporation.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Both I and II.

Rule: In order to obtain a corporate charter, a for-profit corporation must include in its articles of incorporation the name of the corporation and a provision for the authorization of voting stock. In addition, the articles of incorporation must include the names of the incorporators and the name and address of the registered agent. Choices "a", "b", and "d" are incorrect, per the above rule.

QUESTION 324 The corporate veil is most likely to be pierced and the shareholders held personally liable if:

- A. The corporation has elected S corporation status under the Internal Revenue Code.
- B. The shareholders have commingled their personal funds with those of the corporation.
- C. An ultra vires act has been committed.
- D. A partnership incorporates its business solely to limit the liability of its partners.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Generally, a corporation is treated as an entity distinct from its shareholders and shareholders are not liable for the corporation's debts. However, where the shareholders do not treat the corporation as a distinct entity, such as where they commingle their personal funds with the corporation's funds, courts are likely to ignore the corporate form as well.

Choice "a" is incorrect. An election to be taxed like a partnership under Subchapter S is not grounds to pierce the corporate veil.

Choice "c" is incorrect. An ultra vires act is one beyond the corporation's powers. The persons who authorized the ultra vires act can be held personally liable for damages caused, but it is not a ground for piercing the corporate veil. Choice "d" is incorrect. Limiting personal liability is the main reason to incorporate. It is a ground for piercing the corporate veil only if it is done fraudulently (i.e., to avoid paying present creditors).

QUESTION 325 Generally, a corporation's articles of incorporation must include all of the following, except the:

- A. Name of the corporation's registered agent.
- B. Name of each incorporator.
- C. Number of authorized shares.
- D. Quorum requirements.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A corporation's articles of incorporation need not contain any information regarding quorum requirements.

Choices "a", "b", and "c" are incorrect because under the Revised Model Business Corporations Act a corporation's articles of incorporation must include:

- (1) The name of the corporation,
- (2) The name and address of the corporation's registered agent,
- (3) The names and addresses of each of the incorporators, and
- (4) The number of shares authorized to be issued.

QUESTION 326 Which of the following actions may a corporation take without its stockholders' consent?

- A. Consolidate with one or more corporations.
- B. Merge with one or more corporations.
- C. Dissolve voluntarily.
- D. Purchase 55% of another corporation's stock.

Correct Answer: D

Section: Business Environment and Concept

Explanation



Explanation/Reference:

Explanation:

Choice "d" is correct. Directors are free to make most corporate decisions unilaterally. However, decisions that might fundamentally change the nature of the corporation require the consent of the shareholders. The purchase of 55% of another corporation's stock can be quite insignificant to the purchaser and is not a fundamental corporate change.

Choice "a" is incorrect because a consolidation is a fundamental corporate change.

Choice "b" is incorrect because a merger is a fundamental corporate change.

Choice "c" is incorrect because a dissolution is a fundamental corporate change.

QUESTION 327

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.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Amendment of the articles of incorporation, albeit proposed by the directors, cannot usually be effected without the affirmative vote of the shareholders.

Choice "a" is incorrect. The directors ordinarily have the power to repeal bylaws unless the articles or the specific bylaw to be repealed provides otherwise.

Choice "b" is incorrect. The directors have the power to declare dividends at their discretion as long as the dividends do not violate any statute, article provision, bylaw, or contract with a creditor.

Choice "c" is incorrect. Although it seems like there would be a conflict of interest, directors do have the power to set their own compensation, limited only by the fiduciary duties owed to the corporation (e.g., the directors cannot set salaries so high as to constitute waste).

QUESTION 328 Carr Corp. declared a 7% stock dividend on its common

stock. The dividend: A. Must be registered with the SEC pursuant to the Securities Act of 1933.

- B. Is includable in the gross income of the recipient taxpayers in the year of receipt.
- C. Has no effect on Carr's earnings and profits for federal income tax purposes.
- D. Requires a vote of Carr's stockholders.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A stock dividend means that the corporation issues its existing shareholders more stock. In essence, the corporation is merely diluting the proportional ownership interest of existing shares. This has no effect on the corporation's earnings and profits for federal income tax purposes.

Choice "a" is incorrect. There is no requirement that stock dividends be registered with the SEC because no "sale" is involved.

Choice "b" is incorrect. The receipt of a stock dividend is not the recognition of income. It merely divides the stockholders' current ownership interests into more pieces; it does not increase proportional ownership interest in the corporation.

Choice "d" is incorrect. The issuance of dividends, including stock dividends, is at the directors' discretion; shareholders do not vote on dividends.

QUESTION 329

Which of the following rights is a holder of a public corporation's cumulative preferred stock always entitled to?

- A. Conversion of the preferred stock into common stock.
- B. Voting rights.
- C. Dividend carryovers from years in which dividends were not paid, to future years.
- D. Guaranteed dividends.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Cumulative preferred dividends are dividends that must be paid before any dividend can be paid to holders of non-preferred shares. The right to the dividend accumulates if it is not paid in a particular year.

Choice "a" is incorrect. There is no right to convert preferred shares into common stock unless that right is specifically granted. Choice "b" is incorrect. Preferred stock need not have voting rights.

Choice "d" is incorrect. Preferred dividends are not guaranteed. They must be paid before any common shareholder can be paid a dividend, but no dividend might ever be paid.

QUESTION 330

Which of the following securities are corporate debt securities?

<i>Convertible bonds</i>	<i>Debenture bonds</i>	<i>Warrants</i>
Yes	Yes	Yes
Yes	No	Yes
Yes	Yes	No
No	Yes	Yes

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct.

Rules: Bonds are debt securities. Thus, convertible bonds and debenture bonds are debt securities. A warrant is a contractual right to purchase stock, which constitutes a share of corporate equity.

Choices "a", "b", and "d" are incorrect, per the above rules.

QUESTION 331

Under the Revised Model Business Corporation Act, a dissenting stockholder's appraisal right generally applies to which of the following corporate actions?

<u>Short-form Consolidations</u>	<u>Mergers</u>
Yes	Yes
Yes	No
No	Yes
No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. "Yes-Yes."

Rule: Shareholders who are dissatisfied with the terms of a merger, consolidation or sale of assets are permitted to compel the corporation to buy their shares at fair market value. This is known as the right of appraisal or the dissenting right.

Rule: A short-form merger is when a parent merges a 90% or more owned subsidiary into the parent. In this case, only the shareholders of the subsidiary have dissenting rights. Choices "b", "c", and "d" are incorrect, per the above rules.

QUESTION 332

For what purpose will a stockholder of a publicly held corporation be permitted to file a stockholders' derivative suit in the name of the corporation?

- A. To compel payment of a properly declared dividend.
- B. To enforce a right to inspect corporate records.
- C. To compel dissolution of the corporation.
- D. To recover damages from corporate management for an ultra vires management act.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A derivative action is an action by a stockholder in the name of the corporation to recover damages or to seek some other remedy on behalf of the corporation when the corporation does not enforce its own rights. Such actions are often brought when the directors or officers have breached their duty to the corporation and have refused to sue themselves. An ultra vires act is an act outside of a director's or an officer's scope of authority and thus is a breach of duty to the corporation.

Choices "a", "b", and "c" are incorrect, because these would all be causes of action against the corporate directors or officers on behalf of the stockholder to recover damages or seek some other remedy against the corporate directors or officers on behalf of the stockholder, not on behalf of the corporation.

QUESTION 333

Under the Revised Model Business Corporation Act, when a corporation's bylaws grant stockholders preemptive rights, which of the following rights is(are) included in that grant?

	<i>The right to a proportionate share of corporate assets remaining on corporate dissolution</i>	<i>The right to purchase a proportionate share of newly issued stock</i>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Rule: Preemptive rights provide a shareholder with a right of first refusal to buy a share of newly issued shares sufficient to maintain the shareholder's proportionate share of rights in any newly issued shares.

Rule: Preemptive rights do not provide a shareholder with the right to a proportionate share of corporate assets on dissolution. Choice "c" is correct. "No - Yes."

Choices "a", "b", and "d" are incorrect, per the above rules.

QUESTION 334

Which of the following actions may be taken by a corporation's board of directors without stockholder approval?

- A. Purchasing substantially all of the assets of another corporation.
- B. Selling substantially all of the corporation's assets.
- C. Dissolving the corporation.
- D. Amending the articles of incorporation.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Purchasing substantially all the assets of another corporation does not require approval of the buyer's stockholders. Such a transaction would be relatively insignificant if a large corporation purchased substantially all the assets of a much smaller corporation.

Choice "b" is incorrect. Selling substantially all of the corporation's assets is considered to be a fundamental change to the corporation's structure that requires approval by a majority of the shareholders following the board of directors' approval.

Choice "c" is incorrect. Dissolving the corporation is considered to be a fundamental change to the corporation's structure that requires approval by a majority of the shareholders following the board of directors' approval.

Choice "d" is incorrect. Amending the articles of incorporation is considered to be a fundamental change to the corporation's structure that requires approval by a majority of the shareholders following the board of directors' approval.

QUESTION 335 To which of the following rights is a stockholder of a public corporation entitled?

- A. The right to have annual dividends declared and paid.
- B. The right to vote for the election of officers.

- C. The right to a reasonable inspection of corporate records.
- D. The right to have the corporation issue a new class of stock.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Stockholders have a right to inspect certain corporate records.

Choice "a" is incorrect. Declaration of dividends is within the directors' discretion. There is no absolute right of shareholders to receive annual dividends.

Choice "b" is incorrect. Officers are appointed by the directors; they are not elected by the shareholders.

Choice "d" is incorrect. Shareholders do not have a right to force the corporation to issue a new class of stock.

QUESTION 336

A parent corporation owned more than 90% of each class of the outstanding stock issued by a subsidiary corporation and decided to merge that subsidiary into itself. Under the Revised Model Business Corporation Act, which of the following actions must be taken?

- A. The subsidiary corporation's board of directors must pass a merger resolution.
- B. The subsidiary corporation's dissenting stockholders must be given an appraisal remedy.
- C. The parent corporation's stockholders must approve the merger.
- D. The parent corporation's dissenting stockholders must be given an appraisal remedy.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. In a short form merger (one between a parent and a subsidiary 90% of which is owned by the parent), the subsidiary's shareholders have a right to dissent and take advantage of the appraisal remedy. Choice "a" is incorrect. The subsidiary's board is not required to take any action in a short-form merger.

Choice "c" is incorrect. The parent corporation's shareholders have no right to approve or disapprove a short-form merger. Choice

"d" is incorrect. The parent corporation's shareholders have no right to dissent to a short-form merger.

QUESTION 337 Davis, a director of Active

Corp., is entitled to:

- A. Serve on the board of a competing business.
- B. Take sole advantage of a business opportunity that would benefit Active.
- C. Rely on information provided by a corporate officer.
- D. Unilaterally grant a corporate loan to one of Active's shareholders.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. As a director of the corporation Davis may rely on information provided to him/her by a corporate officer. A corporate director is under no obligation to verify information given to him by management (corporate officers).

Choice "a" is incorrect. A director is not entitled to serve on the board of a competing business. Doing so would be a breach of fiduciary duty.

Choice "b" is incorrect. A director may not take sole advantage of a business opportunity that would benefit the corporation. Doing so would be a breach of fiduciary duty.

Choice "d" is incorrect. A director may not unilaterally grant a corporate loan to one of the corporation's shareholders. Directors generally must act through a majority vote at a directors' meeting.

QUESTION 338

Knox, president of Quick Corp., contracted with Tine Office Supplies, Inc. to supply Quick's stationery on customary terms and at a cost less than that charged by any other supplier. Knox later informed Quick's board of directors that Knox was a majority stockholder in Tine. Quick's contract with Tine is:

- A. Void because of Knox's self-dealing.

- B. Void because the disclosure was made after execution of the contract.
- C. Valid because of Knox's full disclosure.
- D. Valid because the contract is fair to Quick.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. If a corporation enters into a contract and a director has a conflict of interest in the transaction, the contract is voidable unless the director makes full disclosure of all of the facts to the disinterested directors or the shareholders, who then approve the transaction, or the director can prove that the transaction was fair to the corporation. The stationery purchase was fair to Quick, since it was purchased at a below-market price. Thus, the contract is valid. Choice "a" is incorrect. A director's self-dealing does not automatically make a contract void. The contract can be upheld if it was fair. Choice "b" is incorrect. A director's self-dealing does not automatically make a contract void. The contract can be upheld if it was fair.

Choice "c" is incorrect. If a corporation enters into a contract and a director has a conflict of interest in the transaction, the contract is voidable unless the director makes full disclosure of all of the facts to the disinterested directors or shareholders, who then approve the transaction, or the director can prove that the transaction was fair. Mere disclosure after the contract was adopted does not automatically render the contract valid.

QUESTION 339

A stockholder's right to inspect books and records of a corporation will be properly denied if the purpose of the inspection is to:

- A. Commence a stockholder's derivative suit.
- B. Obtain stockholder names for a retail mailing list.
- C. Solicit stockholders to vote for a change in the board of directors.
- D. Investigate possible management misconduct.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. In general, a shareholder has a right to inspect the books and records of a corporation for purposes related to the stockholder's interest in the corporation. This right will be denied where the purpose is not reasonably related to their status as a shareholder. Obtaining stockholder names to create a retail mailing list is a personal purpose.

Choices "a", "c", and "d" are incorrect. The following reasons for shareholders to inspect the books of the corporation are reasonably related to their status as shareholders:

- A. To commence a stockholder's derivative suit.
- C. To solicit stockholders to vote for a change in the board of directors.
- D. To investigate possible management misconduct.

QUESTION 340

Which of the following documents would most likely contain specific rules for the management of a business corporation?

- A. Articles of incorporation.
- B. Bylaws.
- C. Certificate of authority.
- D. Shareholders' agreement.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The bylaws are adopted by the incorporators or directors, are not required to be filed, and generally will contain rules desired regarding the operation of the corporation.

Choice "a" is incorrect. Articles of incorporation are filed with the state and contain information regarding the formation of the corporation.

Choice "c" is incorrect. A certificate of authority is filed with the foreign state that a business wishes to do business in and with permission from that state. Choice

"d" is incorrect. A shareholder agreement is a contract between shareholders for any rights or duties agreed upon between the parties.

QUESTION 341 Following the formation of a corporation, which of the following terms best describes the process by which the promoter is released from, and the corporation is made liable for, pre-incorporation contractual obligations? A. Assignment.
B. Novation.
C. Delegation.
D. Accord and satisfaction.

Correct Answer: B

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A promoter is personally liable for the contracts he or she enters into prior to incorporation. A corporation may become liable by adoption of the contract, and through the process of novation (an agreement among all of the parties), the promoter may be released from contractual obligations.

Choice "a" is incorrect. An assignment is a transfer of a contractual duty to perform. After the transfer, both the assignor and assignee may be held liable for performance. The assignor is not, thereby, released from liability.

Choice "c" is incorrect. A delegation is a transfer of a contractual duty to perform. Both the delegor and delegee are liable to perform after the assignment; it does not release the promoter from liability.

Choice "d" is incorrect. An accord is an agreement to change the performance due under a contract. Once the new terms are performed or satisfied, the original contract terms are terminated. Such an agreement does not automatically result in release of a promoter.

QUESTION 342 Which of the following parties is liable to repay an illegal distribution to a corporation?

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

Correct Answer: D

Section: Business Environment and Concept
Explanation



Explanation/Reference:

Explanation:

Choice "d" is correct. Illegal dividends from an insolvent company must be repaid to the corporation for the benefit of the creditors. A shareholder who knowingly accepts an illegal dividend is liable to return it.

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

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

QUESTION 343 Which of the following may not own shares in an S corporation?

- A. Individuals.
- B. Estates.
- C. Trusts.
- D. Corporations.

Correct Answer: D

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Shareholders must be individuals, estates, or certain trusts. Corporations are not permitted to be shareholders of an S corporation. Choices

"a", "b", and "c" are incorrect, per the above Explanation: .

QUESTION 344 Which of the following decreases stockholder equity?

- A. Investments by owners.
- B. Distributions to owners.
- C. Issuance of stock.
- D. Acquisition of assets in a cash transaction.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Distributions to owners, typically in the form of dividends, will serve to reduce stockholders' equity.

Choice "a" is incorrect. Investments by owners, typically in the form of stock purchases or contributions, will serve to increase shareholders' equity.

Choice "c" is incorrect. Issuance of stock by sale will increase shareholders' equity, while issuance of stock dividends will have no effect on total shareholders' equity. Stock dividends will reduce the book value of each share outstanding.

Choice "d" is incorrect. Acquisition of assets with cash will have no effect on total stockholders' equity. The acquisition of assets with cash will effectively reclassify assets from one type to another without impacting liabilities or equity.

QUESTION 345

Food Corp. owned a restaurant called The Ambers. The corporation president, T.J. Jones, hired a contractor to make repairs at the restaurant, signing the contract, "T.J. Jones for The Ambers." Two invoices for restaurant repairs were paid by Food Corp. with corporate checks. Upon presenting the final invoice, the contractor was told that it would not be paid. The contractor sued Food Corp. Which of the following statements is correct regarding the liability of Food Corp.?

- A. It is not liable because Jones is liable.
- B. It is not liable because the corporation was an undisclosed principal.
- C. It is liable because Jones is not liable.
- D. It is liable because Jones had authority to make the contract.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Where an agent enters into a contract on behalf of a principal and discloses the existence and identity of the principal and acts with authority, the principal is liable and the agent is not liable. Here, Jones signed the contract with an indication that he was signing for the corporation. The president of a corporation is an agent of the corporation and has apparent authority to enter contracts that appear to be within the ordinary scope of the corporation's business. The restaurant repairs here appear to be within the scope of Food Corp.'s business. Therefore, Food Corp. will be bound because Jones had at least apparent authority. Choice "a" is incorrect, per the rule stated above.

Choice "b" is incorrect. The president signed as acting on behalf of the corporation, thus disclosing the principal. Choice

"c" is incorrect, per the rule stated above.

QUESTION 346

Which of the following statements describes the same characteristic for both an S corporation and a C corporation?

- A. Both corporations can have more than 100 shareholders.
- B. Both corporations have the disadvantage of double taxation.
- C. Shareholders can contribute property into a corporation without being taxed.
- D. Shareholders can be either citizens of the United States or foreign countries.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Either entity's shareholders may contribute property to the corporations without being taxed and may contribute such property as an exchange for stock as appraised by the directors.

Choice "a" is incorrect. An S corporation may not have more than 100 shareholders, although a C corporation may have as many shareholders as desired. Choice "b" is incorrect. Only the C corporation is subject to the double taxation disadvantage.

Choice "d" is incorrect. Only an S corporation is prohibited from having foreign country shareholders.

QUESTION 347

Smith was an officer of CCC Corp. As an officer, the business judgment rule applies to Smith in which of the following ways?

- A. Because Smith is not a director, the rule does not apply.
- B. If Smith makes, in good faith, a serious but honest mistake in judgment, Smith is generally not liable to CCC for damages caused.
- C. If Smith makes, in good faith, a serious but honest mistake in judgment, Smith is generally liable to CCC for damages caused, but CCC may elect to reimburse Smith for any damages Smith paid.
- D. If Smith makes, in good faith, a serious but honest mistake in judgment, Smith is generally liable to CCC for damages caused, and CCC is prohibited from reimbursing Smith for any damages Smith paid.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The business judgment rule applies to officers as well as directors, who in their capacity, act in a manner the officer believes to be in the best interest of the corporation, and with the care an ordinarily prudent person in a like position would exercise. If the standards of the business judgment rule are met, the officer is not liable to the company for resulting damages. Choices "a", "c", and "d" are incorrect, per the above rule.

QUESTION 348 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.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

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 349

Which of the following statements is correct regarding both debt and common shares of a corporation?

- A. Common shares represent an ownership interest in the corporation, but debt holders do not have an ownership interest.
- B. Common shareholders and debt holders have an ownership interest in the corporation.
- C. Common shares typically have a fixed maturity date, but debt does not.
- D. Common shares have a higher priority on liquidation than debt.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Common shares represent an investment in the corporation whereby the common shareholder becomes a part owner of the corporation. A debt holder is a creditor of the corporation. The corporation has borrowed money from the debt holder and promises to repay at a later date. A debt holder is not an owner of the corporation.

Choice "b" is incorrect. Unlike a common shareholder, a debt holder does not have an ownership interest in the corporation.

Choice "c" is incorrect. Common shares do not have a fixed maturity date, but debt securities do. This answer is backwards.

Choice "d" is incorrect. Upon liquidation of a corporation, the creditors of the corporation are paid first.

After the creditors are paid, the shareholders are paid on a pro rata basis. Thus, debt holders (creditors) have a higher priority than stockholders.

QUESTION 350

Which of the following is an advantage of forming a limited liability company (LLC) as opposed to a partnership?

- A. The entity may avoid taxation.
- B. The entity may have any number of owners.
- C. The owner may participate in management while limiting personal liability.
- D. The entity may make disproportionate allocations and distributions to members.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A member in a limited liability company has limited liability and the ability to manage, while a partner in a general partnership has full liability and the ability to manage.

Choice "a" is incorrect. Generally, both entities' profits are taxable at the ownership level, but a Limited Liability Company may be taxed as an entity if it so elects. Choice "b" is incorrect. Both entities may have any number of owners.

Choice "d" is incorrect. Both entities may make disproportionate allocations and distributions to their owners.

QUESTION 351 In which type of business organization are income taxes always required to be paid by the entity on profits earned as well as by the owners upon distribution thereof?

- A. General partnership.
- B. Limited liability company.
- C. Subchapter C corporation.
- D. Subchapter S corporation.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A Subchapter C corporation is taxed as an entity for income tax purposes.

Additionally, distributions made to stockholders are treated as taxable income to the stockholders. [Note that this type of corporation is more often called a C corporation instead of a Subchapter C corporation.] Choice

"a" is incorrect. A general partnership is not taxed as a separate entity for income tax purposes.

Choice "b" is incorrect. An LLC is not taxed as a separate entity for income tax purposes unless the LLC specifically elects to be taxed like a corporation. [Of course, the word "always" in the question takes care of that.]

Choice "d" is incorrect. A Subchapter S corporation is taxed as a partnership. Thus, it is not taxed as a separate entity for income tax purposes. [Note that this type of corporation is more often called an S corporation instead of a Subchapter S corporation.]

QUESTION 352 Under the Revised Model Business Corporation Act, following what type of corporate acquisition does the acquiring corporation automatically become liable for all obligations of the acquired corporation?

- A. A leveraged buyout of assets.
- B. An acquisition of stock for debt securities.
- C. A cash tender offer.
- D. A merger.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A merger involves one corporation joining with another corporation. The surviving corporation has all of the rights and liabilities of the merged corporation. Thus, the acquiring corporation automatically becomes liable for all obligations of the acquired corporation.

Choice "a" is incorrect. A leveraged buyout is a strategy involving the acquisition of another corporation using a significant amount of borrowed money (bonds or loans). Often, the assets of the corporation being acquired are used as collateral for the loans (in addition to the assets of the acquiring corporation).

The acquiring corporation does not automatically become liable for all (or any) obligations of the acquired corporation if it merely acquires another corporation's assets.

Choice "b" is incorrect. An acquisition of stock for debt securities does not make the acquiring corporation liable for the obligations of the acquired corporation. The acquiring corporation has simply purchased stock. In an acquisition of stock for debt securities, the acquired corporation becomes a subsidiary of the acquiring corporation and the acquired corporation remains a separate entity liable for its own obligations.

Choice "c" is incorrect. A cash tender offer is an offer to purchase a corporation's stock directly from its shareholders at a specified price for a specified period of time. In a cash tender offer, the acquiring corporation does not automatically become liable for all obligations of the acquired corporation. In fact, if there is only an offer, there is no transaction at all.

QUESTION 353

Which of the following actions is required to ensure the validity of a contract between a corporation and a director of the corporation?

- A. An independent appraiser must render to the board of directors a fairness opinion on the contract.
- B. The director must disclose the interest to the independent members of the board and refrain from voting.
- C. The shareholders must review and ratify the contract.
- D. The director must resign from the board of directors.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is clearly the best answer here, although it is not completely correct. Directors owe their corporation a duty of loyalty and must act solely in the best interests of the corporation. If a corporation enters into a contract and a director has a conflict of interest in the transaction, the contract is voidable unless the director makes full disclosure of all of the facts to the disinterested directors or the shareholders who then approve the transaction, or the transaction is fair. Thus, disclosing the interest to the independent members and refraining from voting is one way to ensure the validity of a contract between a director and his or her corporation, but it technically is not required as disclosure to and approval by the shareholders also ensures validity, as does making sure the transaction is fair to the corporation. Nevertheless, the other choices are clearly incorrect - making this the best choice.

Choice "a" is incorrect. A transaction with an interested director will be upheld if it is fair, but it is not necessary to hire an independent appraiser to prove fairness.

Choice "c" is incorrect. One method of approving a contract with an interested director is to disclose all of the material facts to the shareholders and seek their approval. Merely allowing the shareholders to review the contract is not sufficient.

Choice "d" is incorrect. To ensure the validity of a contract between a corporation and a director of the corporation, it is not necessary for the director to resign from the board (i.e., a director is not required to resign because of a conflict of interest). The corporation can approve the conflict if it is disclosed and the director does not participate in the approval process.

QUESTION 354

Which of the following statements is correct regarding the declaration of a stock dividend by a corporation having only one class of par value stock?

- A. A stock dividend is prohibited in such a corporation.
- B. A stock dividend increases a stockholder's proportionate share of corporate ownership.
- C. A stock dividend causes a decrease in the assets of the corporation.
- D. A stock dividend is a corporation's ratable distribution of additional shares of stock to its stockholders.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Stock dividends are dividends in the corporation's own authorized but unissued shares given to existing shareholders on account of their shares.

Choice "a" is incorrect. Despite the fact that a stock dividend in a corporation with only one class of par value stock does not change a shareholder's proportional ownership or affect capitalization of the corporation, nothing prohibits a corporation--even a corporation with only one class of par value stock--from declaring a stock dividend.

Choice "b" is incorrect. With a stock dividend, when there is only one class of stock, each shareholder receives a proportionate amount of stock, resulting in each shareholder owning the same percentage of the corporation after the dividend is issued as he or she owned before the dividend was issued.

Choice "c" is incorrect. When a stock dividend is issued in a corporation's own stock, no assets are distributed and the solvency of the corporation remains the same.

QUESTION 355 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.

Correct Answer: D

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Shareholders have the right to elect and remove directors through the voting process. Choice

"a" is incorrect. Officers are selected by the directors rather than by the shareholders.

Choice "b" is incorrect. Because officers are selected by the directors, generally they may be removed only by the directors.

Choice "c" is incorrect. Dividends generally can be declared only by the directors; shareholders usually do not have any right to declare or vote on a distribution.

QUESTION 356

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.

Correct Answer: A

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. A corporation may elect to be taxed like a partnership under Subchapter S only if it has only one class of stock.

Choice "b" is incorrect. A corporation can elect S corporation status only if its shareholders are individuals, estates, or certain types of trusts.

Choice "c" is incorrect. Foreign shareholders generally are prohibited in an S corporation.

Choice "d" is incorrect. An S corporation can have up to 100 shareholders, but it may have fewer.

QUESTION 357

The president of a company has signed a \$10 million contract with a construction company to build a new corporate office. Which of the following corporate documents sets forth the scope of authority under which this transaction is governed?

- A. Certificate of Incorporation.
- B. Charter.
- C. Bylaws.
- D. Proxy statement.

Correct Answer: C

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "c" is correct. The bylaws usually contain the rules for running the corporation.

Choices "a" and "b" are incorrect. These are possible choices, but not as good an answer as "c". A corporation's articles of incorporation (called a charter in a few states) must set out certain information relevant to formation of the corporation, but it may include any other information that it is not illegal.

However, usually details about intracorporate power are set out in bylaws rather than in the articles or charter.

Choice "d" is incorrect. A proxy statement is a request to shareholders to allow their shares to be voted by a specified person in a specified way. It has nothing to do with a corporate president's authority.

QUESTION 358

A limited liability company taxed under subchapter K of the Internal Revenue Code (the partnership subchapter):

- A. Must pay federal income tax.
- B. Is generally not considered a legal entity separate and apart from its owners.
- C. Must have written articles of organization.
- D. Must provide for apportionment of liability for the company's debts.

Correct Answer: C

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A limited liability company must have written articles of organization, which must be filed with the state.

Choice "a" is incorrect. An LLC taxed under subchapter K of the Internal Revenue Code (the partnership subchapter) does not pay federal income tax; the members are taxed on their share of the LLC's income.

Choice "b" is incorrect. Unlike a general partnership, but like a corporation and a limited partnership, an LLC is considered a legal entity separate and apart from its owners. Choice

"d" is incorrect. An LLC does not have to provide for apportionment of liability for LLC debts; the members of an LLC have limited liability.

QUESTION 359 A partnership agreement must be in writing if:

- A. Any partner contributes more than \$500 in capital.
- B. The partners reside in different states.
- C. The partnership intends to own real estate.
- D. The partnership's purpose cannot be completed within one year of formation.

Correct Answer: D

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Under the statute of frauds, a partnership agreement must be in writing if by its terms the agreement cannot be completed within one year.

Choice "a" is incorrect. No such rule. Although the statute of frauds requires a contract for the sale of goods for \$500 or more to be evidenced by a writing, a writing is not required to contribute more than \$500 in capital to a partnership. Choice

"b" is incorrect. No such rule, a far out distracter.

Choice "c" is incorrect. While a contract to buy or sell real estate will require a writing, a partnership agreement to own/buy real estate need not be in writing.

QUESTION 360

Unless prohibited by the organization documents, a stockholder in a publicly held corporation and the owner of a limited partnership interest both have the right to:

- A. Ownership of the business' assets.
- B. Control management of the business.
- C. Assign their interest in the business.
- D. An investment that has perpetual life.

Correct Answer: C

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Both a shareholder in a publicly held corporation and the owner of a limited partnership interest have a right to assign (sell) their interest. While a shareholder is free to assign his whole ownership interest, a limited partner's assignable interest is limited to the limited partner's interest in profits and losses.

Choice "a" is incorrect. Neither the stockholder of a publicly held corporation nor the owner of a limited partnership interest (or indeed, even a general partnership interest) has an ownership interest in any item of the business' assets--the assets belong to the business and not to the owners of the business.

Choice "b" is incorrect. Stockholders and limited partners generally do not have the right to participate in the management of the business. Choice

"d" is incorrect. A limited partnership interest dissolves upon death of the limited partner and so is not a perpetual investment.

QUESTION 361

Price owns 2,000 shares of Universal 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 Universal is dissolved, which of the following statements is correct?

- A. Universal will be liable to Price as an unsecured creditor for \$10,000.
- B. Universal will be liable to Price as a secured creditor for \$20,000.
- C. Price will have priority over the claims of Universal's bond owners.
- D. Price will have priority over the claims of Universal's unsecured judgment creditors.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. After a dividend is declared but not paid on cumulative preferred stock, the unpaid dividend ranks with other "unsecured" debts.

Choice "b" is incorrect. The unpaid dividend ranks as an "unsecured" not a "secured" debt and Price has no right to a dividend for the second year because no dividend was declared that year. Choice

"c" is incorrect. As an "unsecured" creditor, Price does not have priority over the company's bondholders.

Choice "d" is incorrect. The "unsecured" creditors will share in the "unsecured" category as a whole and not with any priority within the class.

QUESTION 362

A stockholder's right to inspect books and records of a corporation will be properly denied if the stockholder:

- A. Wants to use corporate stockholder records for a personal business.
- B. Employs an agent to inspect the books and records.
- C. Intends to commence a stockholder's derivative suit.
- D. Is investigating management misconduct.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. In general, a shareholder has a right to inspect the books and records of a corporation for purposes reasonably related to his or her status as a shareholder. This right will be properly denied where the purpose is not reasonably related to their status as a shareholder.

Choice "b" is incorrect. In general, a shareholder has a right to inspect the books and records of a corporation for purposes reasonably related to his or her status as a shareholder. A shareholder need not conduct the inspection personally; a shareholder may send an agent such as an attorney or an accountant.

Choices "c" and "d" are incorrect. In general, a shareholder has a right to inspect the books and records of a corporation for purposes reasonably related to his or her status as a shareholder. Choices "c" and "d" are purposes reasonably related to the shareholder's status as a shareholder. Thus, the stockholder would have a right to inspect for those reasons.

QUESTION 363 Generally, a merger of two corporations requires:

- A. That a special meeting be held and that notice and copy of the merger plan be given to all stockholders of both corporations.
- B. Unanimous approval of the merger plan by the stockholders of both corporations.
- C. Unanimous approval of the merger plan by the boards of both corporations.
- D. That all liabilities owed by the absorbed corporation be paid before the merger.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The merger of two corporations requires that a special meeting be held and that notice and copy of the merger plan be given to all stockholders of both companies. A merger generally requires the approval of both the directors and stockholders.

Choice "b" is incorrect. While the stockholders' approval is required, in most states a majority vote is required; no state requires a unanimous vote. Choice

"c" is incorrect. While the board's approval is required, a majority vote and not a unanimous vote is required.

Choice "d" is incorrect. There is no requirement that all liabilities owed by the absorbed corporation be paid before the merger because the merged corporation becomes obligated to pay such liabilities upon the merger.

QUESTION 364

In a member managed LLC, the apparent authority of a member to bind the LLC in dealing with third parties:

- A. Would permit a member to submit a claim against the LLC to arbitration.
- B. Must be derived from the express powers and purposes contained in the operating agreement.
- C. Will be effectively limited by a formal resolution of the members of which third parties are aware.

D. Will be effectively limited by a formal resolution of the members of which third parties are unaware.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. This is really an agency question on apparent authority. Apparent authority is authority that a third party reasonably believes an agent has. If the third party is aware of a restriction on the agent's authority, the third party cannot reasonably believe that the agent has the restricted authority.

Choice "a" is incorrect. Submitting a claim to arbitration is an extraordinary act and so is not within a member's apparent authority.

Choice "b" is incorrect. Apparent authority is derived from what the reasonable person believes is the authority of a member, not the express powers and purposes contained in the operating agreement. Choice

"d" is incorrect. A formal resolution of the members will not be effective to destroy apparent authority if third parties are unaware of the resolution.

QUESTION 365

Unless otherwise provided in a general partnership agreement, which of the following statements is correct when a partner dies?

	<i>The deceased partner's executor would automatically become a partner</i>	<i>The deceased partner's estate would be free from any partnership liabilities</i>	<i>The partnership would be dissolved automatically</i>
A.	Yes	Yes	Yes
B.	Yes	No	No
C.	No	Yes	No
D.	No	No	No



A. Option A

B. Option B

C. Option C

D. Option D

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. "No - No - No."

Upon the death of a general partner:

Rule: A partner's death is an event of dissociation. Where a partner dissociates, the partner's right to participate in the management ceases; the partner's executor does not take the partner's place.

Rule: The partner's estate remains liable for the partner's obligations to the partnership and has a right to the deceased partner's share of distributions.

Rule: Under the Revised Uniform Partnership Act, a partnership does not automatically dissolve on the death of a partner; rather it will dissolve only if 90 days pass and the remaining partners do not wish to continue the partnership. Choices "a", "b", and "c" are incorrect, per the above rules.

QUESTION 366

Under the Revised Model Business Corporation Act, which of the following actions by a corporation would entitle a stockholder to dissent from the action and obtain payment of the fair value of his/her shares?

I. An amendment to the articles of incorporation that materially and adversely affects rights in respect of a dissenter's shares because it alters or abolishes a preferential right of the shares.

II. Consummation of a plan of share exchange to which the corporation is a party as the corporation whose shares will be acquired, if the stockholder is entitled to vote on the plan.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. "Both I and II."

Rule: Shareholders who vote against a share exchange are entitled to payment for fair value of their shares.

Rule: Preferred shareholders who dissent to having their preferential rights altered or abolished have dissenters' rights to be paid the fair value of their shares. Choices

"a", "b", and "d" are incorrect, per the above rules.

QUESTION 367 The apparent authority of a partner to bind the partnership in dealing with third parties:

- A. Will be effectively limited by a formal resolution of the partners of which third parties are aware.
- B. Will be effectively limited by a formal resolution of the partners of which third parties are unaware.
- C. Would permit a partner to submit a claim against the partnership to arbitration.
- D. Must be derived from the express powers and purposes contained in the partnership agreement.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. This is really an agency question on apparent authority. Apparent authority is authority that a third party reasonably believes an agent has. If the third party is aware of a restriction on the agent's authority, the third party cannot reasonably believe that the agent has the restricted authority.

Choice "b" is incorrect. A formal resolution of the partners will not be effective to destroy authority if a third party is aware of the resolution, but not if the third party is unaware of the resolution.

Choice "c" is incorrect. Submitting a claim to arbitration is an extraordinary act. A partner has apparent authority only to enter into transactions apparently carrying on in the usual way the business of the partnership. There is no apparent authority to enter into an extraordinary transaction.

Choice "d" is incorrect. Apparent authority is derived from what a reasonable person believes concerning the authority of a partner based on the partnership's actions toward the third party; authority derived from the express powers and purposes contained in the partnership agreement is actual authority.

QUESTION 368

Grey and Carr entered into a written partnership agreement to operate a hardware store. Their agreement was silent as to the duration of the partnership. Grey wishes to withdraw from the partnership. Which of the following statements is correct?

- A. Unless Carr consents to a withdrawal, Grey must apply to a court and obtain a decree allowing withdrawal.
- B. Grey may not withdraw unless Carr consents.
- C. Grey may withdraw only after notice of the proposed dissolution is given to all partnership creditors.
- D. Grey may withdraw from the partnership at any time.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct.

Rule: Where a partnership agreement does not state the duration of the partnership, the partners may withdraw at any time. The partner need not obtain consent of the other partners or of the court.

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

Choice "c" is incorrect. A partner has no duty to inform creditors of his intent to withdraw in order for the withdrawal to be effective (although notice is needed to limit the partner's personal liability).

QUESTION 369

The limited liability of the shareholders of a closely-held corporation will most likely be disregarded if the shareholders:

- A. Lend money to the corporation.
- B. Are also corporate officers, directors, or employees.
- C. Undercapitalized the corporation when it was formed.
- D. Formed the corporation solely to limit their personal liability.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The "corporate veil" can be pierced in situations in which the corporation was undercapitalized at formation, where it is the alter ego of the shareholders, or when it used to perpetrate a fraud.

Choice "a" is incorrect. Shareholders may lend money to their corporation. This does not make such shareholders personally liable for the corporation's debt.

Choice "b" is incorrect. Officers, directors, and employees are not personally liable for the corporation's debt, and there is no reason to change this role merely because such persons also own shares. Choice "d" is incorrect. The desire to limit liability is a valid reason to adopt the corporate form and will not, by itself, allow the "corporate veil" to be pierced.

QUESTION 370

Acorn and Bean were general partners in a farm machinery business. Acorn contracted, on behalf of the partnership, to purchase 10 tractors from Cobb Corp. Unknown to Cobb, Acorn was not authorized by the partnership agreement to make such contracts. Bean refused to allow the partnership to accept delivery of the tractors and Cobb sought to enforce the contract. Cobb will:

- A. Lose because Acorn's action was beyond the scope of Acorn's implied authority.
- B. Prevail because Acorn had implied authority to bind the partnership.
- C. Prevail because Acorn had apparent authority to bind the partnership.
- D. Lose because Acorn's express authority was restricted, in writing, by the partnership agreement.

Correct Answer: C

Section: Business Environment and Concept

Explanation



Explanation/Reference:

Explanation:

Choice "c" is correct. A general partner has apparent authority to bind the partnership and other partners in respect to all ordinary transactions within the apparent scope of the partnership business. A farm machinery business probably regularly purchases tractors. Thus, there was apparent authority here.

Choices "a" and "b" are incorrect. Implied authority is authority that an agent reasonably believes he or she was given by the principal along with any express authority. Because Acorn knew that he did not have express authority to make the contracts here, he could not reasonably believe that he had implied authority to do so.

Choice "d" is incorrect. The seller was not aware of Acorn's lack of express authority. Therefore, Cobb relied on Acorn's apparent authority.

QUESTION 371

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

- A. The ACH Associates oral partnership agreement was valid.
- B. The ACH Associates oral partnership agreement was invalid because the partnership lasted for more than one year.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A partnership agreement does not have to be in writing to be valid. If the partners want to enforce an agreement to be partners for more than one year, that agreement must be in writing, but merely having the partnership last for more than one year does not make an oral partnership agreement invalid.

QUESTION 372

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

A. Anchor, Chain, and Hook jointly owning and conducting a business for profit establishes a partnership relationship.

B. Anchor, Chain, and Hook jointly owning income producing property establishes a partnership relationship.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A partnership is defined as an association of two or more persons who agree to carry on as co-owners a business for profit. Merely owning income-producing property jointly is not sufficient.

QUESTION 373

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

A. Anchor's share of ACH Associates' 1993 profits was \$20,000.

B. Hook's share of ACH Associates' 1993 profits was \$30,000.

Correct Answer: B

Section: Business Environment and Concept

Explanation



Explanation/Reference:

Explanation:

Choice "b" is correct. Unless otherwise agreed, partners share profits equally. Here, the partners agreed to share profits on the basis of their contributions, which were in a ratio of 1:2:3 respectively for Anchor, Chain, and Hook. Thus, Anchor's share of the 1993 profits was \$10,000, Chain's share was \$20,000, and Hook's share was \$30,000.

QUESTION 374

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

A. Anchor's capital account would be reduced by 1/3 of any 1994 losses.

B. Hook's capital account would be reduced by 1/2 of any 1994 losses.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. If the partnership agreement is silent on how losses will be shared, they are shared in the same manner as profits. Here, the partners agreed to share profits on the basis of their contributions, which were in a ratio of 1:2:3 respectively for Anchor, Chain, and Hook. Thus, Anchor is liable for one-sixth of the loss, Chain is liable for 1/3 of the loss, and Hook is liable for 1/2 of the loss.

QUESTION 375

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

- A. Ace Automobile Co. would lose a suit brought against ACH Associates because Hook, as a general partner, has no authority to bind the partnership.
- B. Ace Automobile Co. would win a suit brought against ACH Associates because Hook's authority continues during dissolution.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A partner's authority to bind the partnership continues after dissolution to persons who have extended credit to the partnership previously and who are without notice of the dissolution. The facts state that Hook had previously purchased cars for the partnership from Ace, and presumably the purchases were on credit. Since nothing in the facts indicates that Ace was given notice of the dissolution, the partnership will be bound.

QUESTION 376

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed \$5,000; Chain \$10,000; and Hook \$15,000. For the year ended December 31, 1993, ACH Associates had profits of \$60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners. Determine whether (A) or (B) is correct. Select the answer that corresponds to the correct statement.

- A. ACH Associates and Hook would be the only parties liable to pay any judgment recovered by Ace Automobile Co.
- B. Anchor, Chain, and Hook would be jointly and severally liable to pay any judgment recovered by Ace Automobile Co.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Since Ace brought suit against both the partnership and the individual partners, if judgment is rendered against the partnership, all partners could be held jointly and severally liable.

QUESTION 377

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock. Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held.

For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers.

- A. Amber Corp. must be formed under a state's general corporation statute.
- B. Amber Corp.'s articles of incorporation must include the names of all stockholders.
- C. Amber Corp. must include its corporate bylaws in the incorporation documents filed with the state.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A corporation must be formed by compliance with the state's corporation statute.

Choice "b" is incorrect. The articles need not contain the names of the stockholders.

Choice "c" is incorrect. Bylaws do not have to be in the articles; they are usually adopted at the first directors' meeting.

QUESTION 378

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock. Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held.

For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers. Amber Corp.'s initial bylaws ordinarily would be adopted by its:

- A. Stockholders.
- B. Officers.
- C. Directors.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Bylaws usually are adopted by the initial directors.

QUESTION 379

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock.

Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held.

For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers. Amber Corp.'s directors are elected by its:

- A. Officers.
- B. Outgoing directors.
- C. Stockholders.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Directors are elected by the stockholders.

QUESTION 380

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock.

Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held.

For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers. Amber Corp.'s officers ordinarily would be elected by its:

- A. Stockholders.
- B. Directors.
- C. Outgoing officers.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Officers usually are selected by the directors.

QUESTION 381

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock.

Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held.

For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers. Amber Corp.'s day-to-day business ordinarily would be operated by its:

- A. Directors.
- B. Stockholders.
- C. Officers.

Correct Answer: C

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Stockholders have no day-to-day control; management power of a corporation is vested in the directors, but they usually delegate day-to-day management duties to the officers.

QUESTION 382

In 1990, Amber Corp., a closely held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock. Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held. For this question refer to the formation of Amber Corp. and the rights and duties of its stockholders, directors, and officers.

- A. Adams, Frank, and Berg must be elected as directors because they own 55% of the issued and outstanding stock.
- B. Adams, Frank, and Berg must always be elected as officers because they own 55% of the issued and outstanding stock.
- C. Adams, Frank, and Berg must always vote for each other as directors because they have a voting agreement.

Correct Answer: C

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Shareholders in a voting agreement must vote their shares in accordance with the agreement. There is no requirement that majority shareholders be elected as directors or officers.

Business Cycles and Reasons for Business Fluctuations

QUESTION 383 An increase (shift right) in aggregate demand causes:

- A. An increase in the price level and a decrease in real GDP.
- B. A decrease in the price level and an increase in real GDP.
- C. An increase in the price level and an increase in real GDP.
- D. A decrease in the price level and a decrease in real GDP.

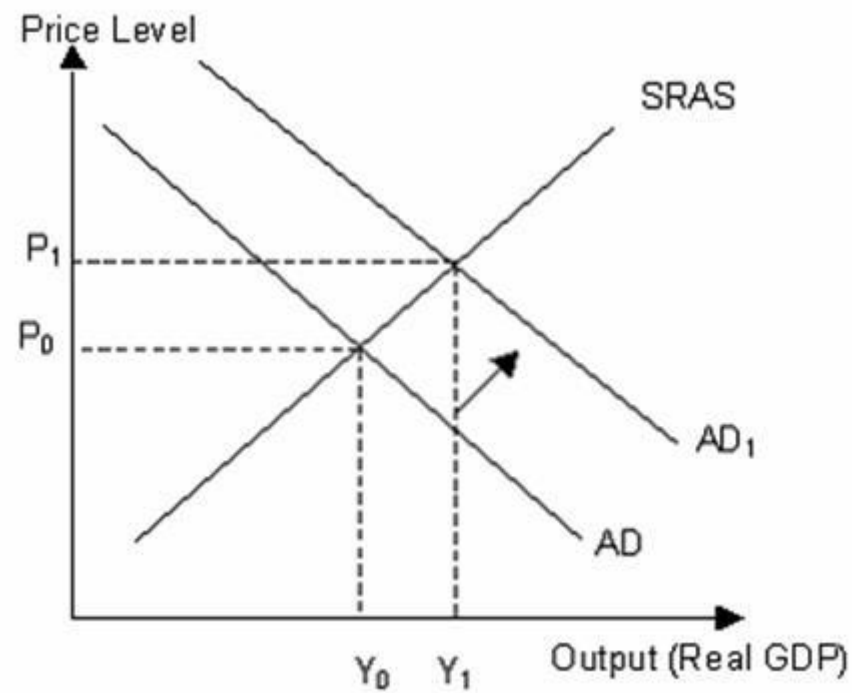


Correct Answer: A

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:



Choice "c" is correct. As shown above, an increase in aggregate demand causes the equilibrium price level to rise and equilibrium output (real GDP) to increase. Choice "a" is incorrect. As shown above, equilibrium output increases, not decreases. Choice "b" is incorrect. As shown above, the equilibrium price level increases, not decreases. Choice "d" is incorrect. As shown above, the equilibrium price level increases, not decreases.

QUESTION 384

The trough of a business cycle is generally characterized by:

- A. Shortages of essential raw materials and rising costs.
- B. Increasing purchasing power and increasing capital investments.
- C. Unused productive capacity and an unwillingness to risk investments.
- D. Declining purchasing power and unused productive capacity.



Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The trough of a business cycle is an economic low point with no positive indicators for the future. It is characterized by unused productive capacity and an unwillingness to risk new investments. Choice

"a" is incorrect. Shortages may occur during a peak.

Choice "b" is incorrect. Increasing purchasing power and increasing capital investments come with recovery. Choice

"d" is incorrect. Declining purchasing power comes with inflation; unlikely in a trough.

QUESTION 385

During a recession:

- A. Output (real GDP) will be increasing.
- B. The natural rate of unemployment will increase dramatically.
- C. Potential output will exceed actual output.
- D. Actual output will exceed potential output.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. During a recession, potential output (real GDP) will exceed actual output (real GDP). Choice

"a" is incorrect. Real GDP is falling during a recession.

Choice "b" is incorrect. The natural rate of unemployment will not be affected by the various phases of the business cycle. Actual unemployment will change with the cycle. Choice

"d" is incorrect. Actual output will not exceed potential output except at the peak of the cycle, and perhaps not then.

QUESTION 386 A recession
can be caused by:

- A. An increase in aggregate demand.
- B. A decrease in aggregate supply.
- C. A decrease in aggregate demand.
- D. Both "b" and "c".

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Both choices "b" and "c" can cause a recession. A recession is defined as a period of falling GDP and rising unemployment. GDP will fall if there is a decrease in aggregate demand or a decrease in aggregate supply.

Choice "a" is incorrect. An increase in aggregate demand will cause GDP to increase NOT decrease. Choice "b" is incorrect, per the above Explanation. Choice "c" is incorrect, per the above Explanation.

QUESTION 387 A period during which real GDP is rising and unemployment is
falling is called a(n):

- A. Recession.
- B. Peak.
- C. Expansion.
- D. Trough.



Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. During an expansion, real GDP is rising and unemployment is falling.

Choice "a" is incorrect. A recession is when real GDP is falling NOT rising.

Choice "b" is incorrect. A peak is the highest point of economic activity. It is the point where real GDP is at its highest level in the cycle and unemployment is at its lowest level in the cycle.

Choice "d" is incorrect. A trough is the lowest level of economic activity. It is the point where real GDP is at its lowest level in the cycle and unemployment is at its highest level in the cycle.

QUESTION 388 Which of the following might be considered the most expansionary set
of fiscal policies?

- A. Increase government purchases, increase in taxes.
- B. Increase government purchases, decrease in taxes.
- C. Decrease in taxes, increase in the money supply.
- D. Increase in government purchases, increase in the money supply.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Expansionary fiscal policy involves increasing government purchases and/or decreasing taxes. Both increases in government spending and decreases in taxes cause the aggregate demand curve to shift right and thus cause real GDP (output) to increase.

Choice "a" is incorrect. An increase in taxes is an example of contractionary fiscal policy.

Choice "c" is incorrect. An increase in the money supply is expansionary monetary policy (not fiscal policy). Choice "d" is incorrect per above Explanation.

QUESTION 389 An increase in government spending will tend to cause:

- A. Real GDP to fall and unemployment to rise.
- B. Real GDP to rise and unemployment to fall.
- C. Real GDP to rise and unemployment to rise.
- D. Real GDP to fall and unemployment to fall.

Correct Answer: B

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. An increase in government spending causes an increase in aggregate demand (i.e., causes the aggregate demand curve to shift right). As a result, an increase in government spending causes real GDP to rise and unemployment to fall.

Choice "a" is incorrect. Real GDP will rise, not fall.

Choice "c" is incorrect. Unemployment will fall, not rise. Choice

"d" is incorrect. Real GDP will rise, not fall.

QUESTION 390 An increase in the personal income tax will tend to cause:

- A. Real GDP to fall and unemployment to rise. B. Real GDP to rise and unemployment to fall.
- C. Real GDP to rise and unemployment to rise.
- D. Real GDP to fall and unemployment to fall.



Correct Answer: A

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. An increase in the personal income tax will cause a decrease in aggregate demand (i.e., causes the aggregate demand curve to shift left). As a result, an increase in taxes causes real GDP to fall and unemployment to rise.

Choice "b" is incorrect. Real GDP will fall, not rise.

Choice "c" is incorrect. Real GDP will fall, not rise.

Choice "d" is incorrect. Unemployment will rise, not fall.

QUESTION 391 Which one of the following most accurately describes the normal sequence of a business cycle?

- A. Expansion, contraction, trough, and peak. B. Expansion, peak, contraction, and trough. C. Peak, contraction, expansion, and trough.
- D. Trough, contraction, expansion, and peak.

Correct Answer: B

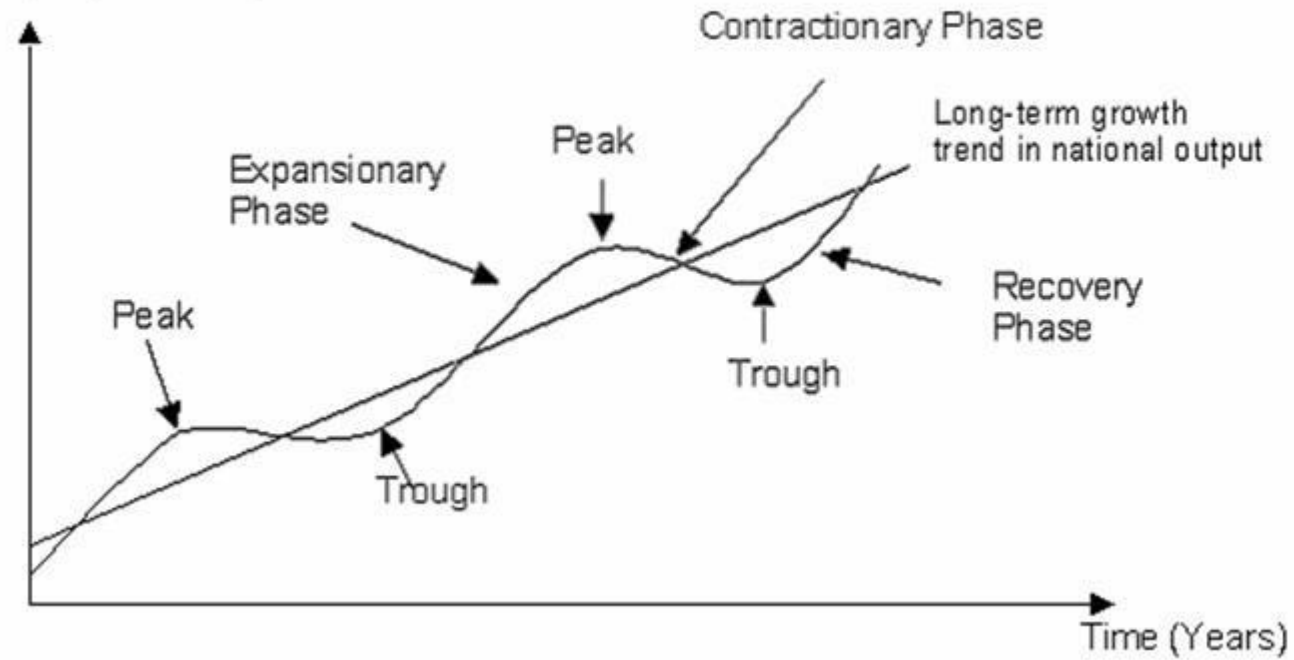
Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Graph A

Output (Real GDP)



Choice "b" is correct. The sequence of a typical business cycle includes an expansionary phase, a peak of economic activity, a contractionary phase, and a trough of economic activity. Choice "a" is incorrect. A peak does not follow a trough.

Choice "c" is incorrect. A trough does not follow an expansion.

Choice "d" is incorrect. A contraction does not follow a trough.

QUESTION 392 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.

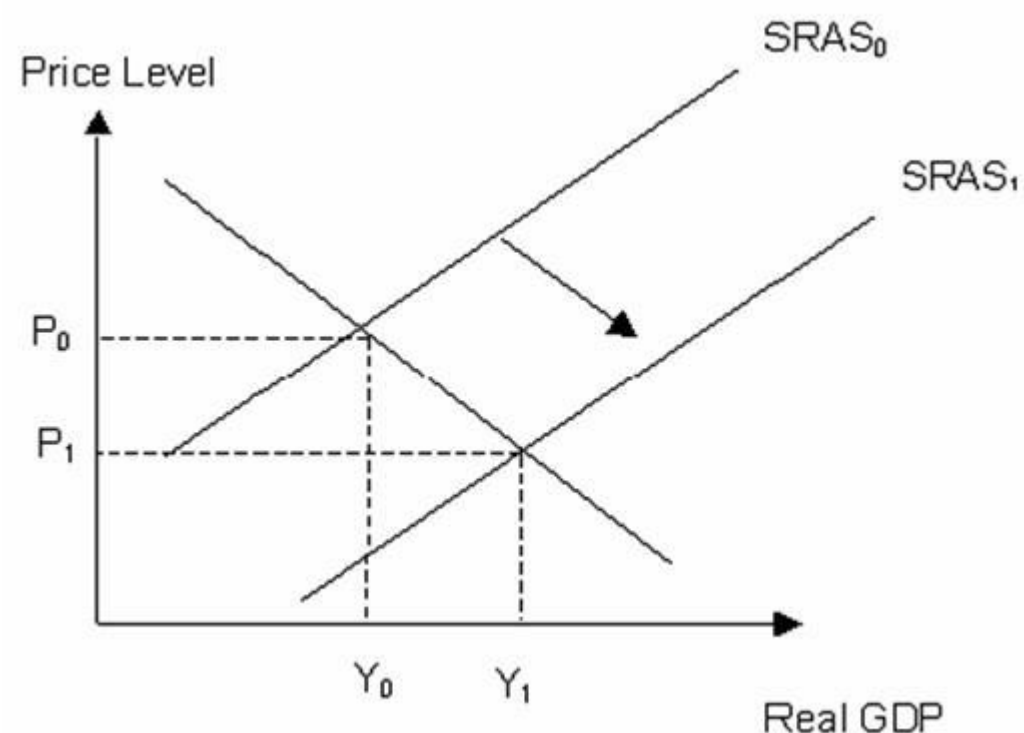
Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:



Choice "a" is correct. A shift right in short run aggregate supply causes output to increase and the price level to fall.
 Choice "b" is incorrect. Real output would rise, not fall.
 Choice "c" is incorrect. The price level would fall, not rise. Choice
 "d" is incorrect. Real output would rise, not fall.

QUESTION 393 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.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. As aggregate demand falls, the unemployment rate rises so employment would decrease.

Choice "a" is incorrect. The price level would fall, not rise.

Choice "c" is incorrect. Real GDP would fall, not rise.

Choice "d" is incorrect. The unemployment rate would rise, not fall.

QUESTION 394 If an economy is currently experiencing both full employment and price stability, a major tax reduction will probably cause:

- A. An increase in the unemployment rate.
- B. An acceleration in the inflation rate, unless government expenditures are also reduced.
- C. No change in real GDP or the price level.
- D. A decrease in consumption.

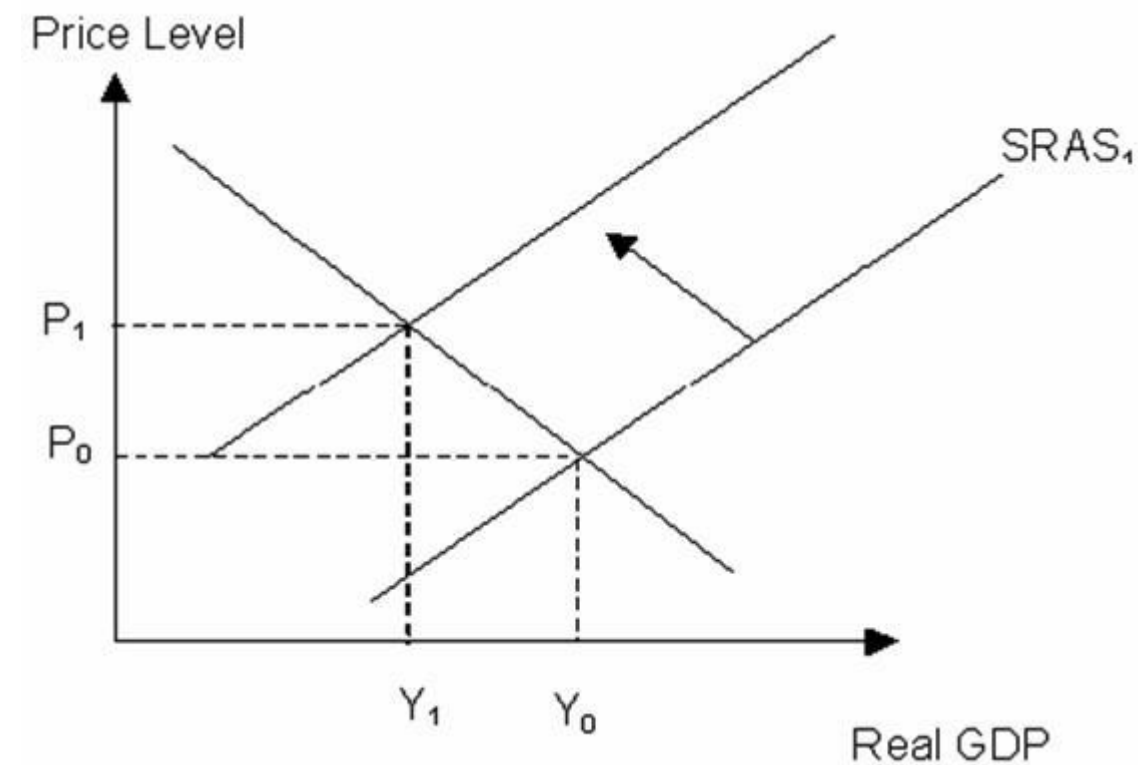
Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:



Choice "b" is correct. A tax cut shifts the aggregate demand curve to the right causing the price level and therefore the inflation rate to rise.

Choice "a" is incorrect. The unemployment rate would fall, not rise.

Choice "c" is incorrect. The price level would rise, not remain unchanged.

Choice "d" is incorrect. Consumption would rise as disposable income rises, not fall.

QUESTION 395 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.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. If the dollar gains in value, net exports will suffer as U.S. goods become more expensive overseas; hence aggregate demand will decrease. The supply of foreign goods domestically should increase as imports become cheaper.

Choice "a" is incorrect. Demand should decrease, not increase.

Choice "c" is incorrect. Irrelevant to the question.

Choice "d" is incorrect. Demand should decrease, not remain the same.

QUESTION 396 A large increase in nominal wages, perhaps orchestrated by unions, would most likely result in:

- A. An increase in real GDP and a decrease in the price level.

- B. A decrease in real GDP and an increase in the price level.
- C. A decrease in real GDP and a decrease in the price level.
- D. An increase in real GDP and an increase in the price level.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. An increase in nominal wages represents an increase in input costs. This would shift the aggregate supply curve to the left resulting in a decrease in real GDP and an increase in the overall price level. Choice "a" is incorrect. Real GDP would decrease, not increase.
Choice "c" is incorrect. The price level would increase, not decrease.
Choice "d" is incorrect. Real GDP would decrease, not increase.

QUESTION 397 Economic fluctuations (or business cycles) are best described as:

- A. Long run increases in a nation's standard of living.
- B. Changes in the profits of a given firm from one year to the next.
- C. Fluctuations of equal duration and equal severity in the level of economic activity over time.
- D. Fluctuations in the level of economic activity, relative to a long-term growth trend.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. By the definition of business cycles.
Choice "a" is incorrect. This is economic growth.
Choice "b" is incorrect. Business cycles refer to overall economic activity not the activity of one firm.
Choice "c" is incorrect. Business cycles are not predictable and are not of equal duration nor of equal severity.



QUESTION 398 Which of the following would most likely cause real GDP to increase the most:

- A. A rise in interest rates and a rise in input costs.
- B. A fall in interest rates and a fall in input costs.
- C. A rise in wealth and a rise in interest rates.
- D. A rise in consumer confidence and a fall in government spending.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A decline in interest rates would cause the aggregate demand curve to shift right, which increases real GDP. Similarly, a decline in input costs would cause the aggregate supply curve to shift right, which also increases real GDP.
Choice "a" is incorrect. Both of these events would cause real GDP to decline.
Choice "c" is incorrect. A rise in interest rates would cause real GDP to decline, not increase.
Choice "d" is incorrect. A decline in government spending would cause real GDP to decline, not increase.

QUESTION 399 At the peak of a business cycle:

- A. Output (real GDP) tends to be below the potential level of output.

- B. There is likely to be an excess supply of labor and business inventories are likely to be high.
- C. The overall price level is likely to be falling.
- D. Capacity constraints and labor shortages are likely to put upward pressure on the overall price level.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The peak of a business cycle marks the highest point of economic activity. At that point, firms are likely to face capacity constraints and labor shortages, which will put upward pressure on the overall price level. Choice

"a" is incorrect. Real GDP is likely to be above, not below, its potential level.

Choice "b" is incorrect. Business inventories are likely to be low, not high, and there is likely to be excess demand for labor not an excess supply of labor. Choice

"c" is incorrect. The overall price level is likely to be rising not falling.

QUESTION 400 Which of the following segments of the economy will be least affected by the business cycle?

- A. Commercial construction industry.
- B. Machinery and equipment industry.
- C. Residential construction industry.
- D. Healthcare industry.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The business cycle is the rise and fall of economic activity relative to its long-term growth trend. During a contraction or a recession, most industries experience a decline in sales and profits. Similarly, during an expansion, most industries experience an increase in sales and profits.

However, health care services are typically not affected by business cycles. People need medical services regardless of whether or not the economy is doing well. Thus, the health care industry is the least affected by the business cycle.

Choice "a" is incorrect. During a downturn in economic activity (recession or contraction), firm investment in new plants and equipment typically drops off substantially. Thus, the demand for commercial construction is typically low during a contraction and high during an expansion. Thus, the commercial construction industry is sensitive to the business cycle.

Choice "b" is incorrect. During a downturn in economic activity (recession or contraction) firm investment in new plants and equipment typically drops off substantially. Thus, the machinery and equipment industry is sensitive to business cycles. Sales grow during an expansion, but they tend to decline during a contraction or recession.

Choice "c" is incorrect. The residential construction industry is sensitive to interest rates, unemployment rates, and consumer wealth. All of these fluctuate with the business cycle. As a result, the residential construction industry is sensitive to the business cycle.

QUESTION 401 An auditor is required to obtain an understanding of the entity's business, including business cycles and reasons for business fluctuations. What is the audit purpose most directly served by obtaining this understanding?

- A. To enable the auditor to accurately identify significant deficiencies.
- B. To assist the auditor to accurately interpret information obtained during an audit.
- C. To allow the auditor to more accurately perform tests of controls.
- D. To decide whether it will be necessary to perform analytical procedures.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. As part of audit planning, the auditor should obtain an understanding of the entity's business. This understanding enables the auditor to better understand events, transactions, and practices that may affect the financial statements, to plan and perform appropriate audit tests, and to properly understand and evaluate the results of those tests.

Choice "a" is incorrect. Obtaining an understanding of the entity's business would not be particularly helpful in identifying significant deficiencies. Significant deficiencies in internal control are typically identified during the fieldwork stage of the audit.

Choice "c" is incorrect. Obtaining an understanding of the entity's business would not result in a more accurate performance of tests of controls. Accurate performance of audit tests is dependent upon factors such as existence of an appropriate audit trail, client cooperation, training and supervision of audit staff, etc.

Choice "d" is incorrect. Analytical procedures are always required in an audit during the planning and overall review stages.

QUESTION 402

Which of the following statements is correct if there is an increase in the resources available within an economy?

- A. More goods and services will be produced in the economy.
- B. The economy will be capable of producing more goods and services.
- C. The standard of living in the economy will rise.
- D. The technological efficiency of the economy will improve.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. If there is an increase in the resources available in an economy, the economy will be capable of producing more goods and services. This increase is really an increase in the long-run aggregate supply (potential GDP). On the aggregate supply and demand chart, the long-run aggregate supply line (LRAS) is the vertical line that represents the potential or equilibrium level of output. If that line shifts to the right, then the economy is capable of expanding, but it will not automatically expand just because the line shifts to the right.

Choice "a" is incorrect. Just because there is an increase in the resources available in an economy, it does not mean that more goods and services will automatically be produced. There would have to be increased demand (a shift upward in the aggregate demand line) for more goods and services to actually be produced.

Choice "c" is incorrect. If there is an increase in the resources available in an economy, the standard of living in the economy will not necessarily rise. It could rise, but it will not necessarily do that.

Choice "d" is incorrect. If there is an increase in the resources available in an economy, the technological efficiency of the economy will not automatically improve. This statement is backwards. An increase in technological efficiency of an economy will normally increase the resources available in the economy by increasing productivity. Economic Measures and Reasons for Changes in the Economy

QUESTION 403 A

period of inflation:

- A. Increases the price level, which benefits those who are entitled to receive specific amounts of money.
- B. Enhances the positive relationship between the price level and the purchasing power of money.
- C. Harms anyone who has an obligation to pay a specific amount and benefits anyone who is entitled to receive a specific amount.
- D. Increases the price level, which is negatively related to the purchasing power of money.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A period of inflation increases the price level, which is negatively related to the purchasing power of money (inflation erodes the value of money).

Choice "a" is incorrect. When price levels increase, those with fixed amounts of money are hurt.

Choice "b" is incorrect. The relationship between price levels and the purchasing power of money is negative, or inverse.

Choice "c" is incorrect. Inflation helps anyone with a fixed obligation since the debt can be repaid in inflated dollars. Those receiving a specific fixed amount are harmed.

QUESTION 404

Which of the following would lead to the most inflation?

- A. Both aggregate demand and aggregate supply increase.
- B. Both aggregate demand and aggregate supply decrease.
- C. Aggregate demand increases and aggregate supply decreases.
- D. Aggregate demand decreases and aggregate supply increases.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Choice "c" contains both demand-pull inflation (when the aggregate demand curve shifts right) and cost-push inflation (when the aggregate supply curve shifts left). An increase in aggregate demand causes output to rise and the price level to rise. A decrease in aggregate supply causes output to fall and the price level to rise. Thus, an increase in aggregate demand and a decrease in aggregate supply is the most inflationary. Choice "a" is incorrect. If aggregate supply increases, the price level will fall (reducing inflation).

Choice "b" is incorrect. If aggregate demand decreases, the price level will fall (reducing inflation). Choice

"d" is incorrect per above Explanation.

QUESTION 405 Which of the following is not consistent with full employment?

- A. An unemployment rate greater than zero.
- B. Structural unemployment.
- C. Cyclical unemployment.
- D. Frictional unemployment.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. When the economy is operating at full employment, there is no cyclical unemployment. When the economy is operating at full employment, there is still some unemployment known as the natural rate of unemployment, which does not include cyclical unemployment.

Choice "a" is incorrect. There is still some unemployment (frictional, structural, and seasonal) when the economy is operating at full employment. Choice

"b" is incorrect, per the above Explanation.

Choice "d" is incorrect, per the above Explanation.

QUESTION 406 Cyclical unemployment results from:

- A. Skills of workers not corresponding to jobs available.
- B. The time it takes to match qualified workers with available jobs.
- C. Seasonal decreases in demand for labor.
- D. A recession in the economy.



Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Cyclical Unemployment is caused by the business cycle. It tends to rise during a recession and fall during an expansion. Choice

"a" is incorrect. This is an example of structural unemployment.

Choice "b" is incorrect. This is an example of frictional unemployment.

Choice "c" is incorrect. This is an example of seasonal unemployment.

QUESTION 407

A sharp rise in the price of oil (a major input), would result in:

- A. Cost (Push) inflation.
- B. Demand (Pull) inflation.
- C. An increase in aggregate demand.
- D. An increase in aggregate supply.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Cost (Push) inflation is inflation caused by a shift left in aggregate supply. An increase in input costs, such as a sharp increase in the price of oil, will cause the aggregate supply curve to shift left and thus increase the aggregate price level causing inflation.

Choice "b" is incorrect. Demand (Pull) inflation is inflation caused by a shift right in aggregate demand.

Choice "c" is incorrect. An increase in the price of oil causes the aggregate supply curve to shift, not the aggregate demand curve. Choice

"d" is incorrect. An increase in the price of oil will cause aggregate supply to decrease (shift left), not increase.

QUESTION 408

During a period of high inflation, which of the following groups in society would be most likely to gain?

- A. Those with a fixed income.
- B. Those with a fixed amount of debt.
- C. Those holding a large amount of money.
- D. Workers under contract without a cost of living adjustment.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. During a period of high inflation, those with a fixed amount of debt will repay their debt with inflated dollars and are thus likely to gain.

Choice "a" is incorrect. Those with a fixed income will see the purchasing power of their income erode and are thus likely to be hurt.

Choice "c" is incorrect. Those holding a large amount of money will see the purchasing power of their money erode and are thus likely to be hurt. Choice

"d" is incorrect. Cost of living adjustments take inflation into account, thus these individuals are likely to be unaffected.

QUESTION 409 Frictional unemployment refers to unemployment resulting from:

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



Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

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

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

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

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

QUESTION 410

The measure most often used to compare standards of living across countries or across time is:

- A. Government spending.
- B. Real GDP.
- C. Real consumption expenditures.
- D. Real GDP per capita.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Real GDP per capita is real GDP divided by population. Real GDP per capita is typically used to compare standards of living across countries or across time. By dividing real GDP by population, this measure adjusts for differences in the size of countries and for differences in population over time.

Choice "a" is incorrect. Government spending is not a measure of the standard of living of a country.

Choice "b" is incorrect. Countries with larger populations tend to have higher levels of real GDP. This however does not mean they have a higher standard of living. To adjust for differences in population, real GDP per capita is typically used to compare standards of living, not real GDP.

Choice "c" is incorrect. Real consumption expenditures are only a part of real GDP and thus do not measure all economic activity. Furthermore, real consumption expenditures do not adjust for differences in population. It is therefore not used as a measure of the standard of living.

QUESTION 411 The determination of gross domestic product (GDP) by the expenditure approach would include:

- A. Net exports.
- B. Business profits.
- C. Compensation to employees.
- D. A capital consumption allowance.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The expenditure approach to computing GDP includes:

Consumption

Net exports

Government expenditures

Capital investment

Choices "b", "c", and "d" are incorrect, per the Explanation above.



QUESTION 412 Under the expenditure approach, GDP can be calculated as the sum of:

- A. Consumption, money supply, government purchases, and exports.
- B. Consumption, investment, transfer payments, and imports.
- C. Consumption, investment, government purchases, and net exports.
- D. Consumption, investment, government purchases, and foreign exchange.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Under the expenditure approach, GDP is calculated as the sum of: consumption expenditures + investment expenditures + government purchases + net exports. Choice

"a" is incorrect. See definition above.

Choice "b" is incorrect. See definition above.

Choice "d" is incorrect. See definition above.

QUESTION 413 The discount rate set by the Federal Reserve is the:

- A. Rate that commercial banks charge for loans to each other.
- B. Rate that commercial banks charge for loans to the general public.
- C. Rate that the central bank charges for loans to commercial banks.
- D. Ratio of a bank's reserves to its demand deposits.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The discount rate refers to the rate established by the Federal Reserve for shortterm (often overnight) loans the Fed makes to member banks. Choice

"a" is incorrect. The discount rate is the rate the Federal Reserve charges.

Choice "b" is incorrect per above Explanation: .

Choice "d" is incorrect. This would be the bank's reserve ratio - not the discount rate.

QUESTION 414

All of the following actions are valid tools that the Federal Reserve Bank uses to control the supply of money, except:

- A. Selling government securities.
- B. Changing the reserve ratio.
- C. Raising or lowering the discount rate.
- D. Printing money when the money supply appears low.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The treasury prints money. The Fed must increase the money supply through:

1. Federal open market committee (FOMC) purchasing or selling government securities,
2. Raising or lowering the discount rate, or
3. Changing the reserve ratio.

Choices "a", "b", and "c" are incorrect because they are all valid tools to control the supply of money.



QUESTION 415

If the Federal Reserve wanted to implement an expansionary monetary policy, which one of the following actions would the Federal Reserve take?

- A. Raise the reserve requirement and the discount rate.
- B. Purchase additional U.S. government securities and lower the discount rate.
- C. Raise the discount rate and sell U.S. government securities.
- D. Lower the discount rate and raise the reserve requirement.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Fed purchases of government securities increase the money supply (putting money into circulation), and lowering the discount rate encourages borrowing by member banks and increases the money supply. Hence, these measures would help implement an expansionary monetary policy.

Choice "a" is incorrect. Raising the reserve requirement and the discount rate would have the opposite effect of decreasing the money supply.

Choice "c" is incorrect. Raising the discount rate and selling government securities would reduce the money supply.

Choice "d" is incorrect. Raising the reserve requirement would decrease the money supply, but lowering the discount rate would increase the money supply.

QUESTION 416 To decrease the money supply, the Fed might:

- A. Sell government securities on the open market. B.
- Buy government securities on the open market.
- C. Decrease the required reserve ratio.

D. Lower the discount rate.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. To decrease the money supply, the Fed can: (1) sell government securities in the open market, (2) increase the discount rate, and (3) increase the required reserve ratio. Choice

"b" is incorrect. The Fed should sell (not buy) securities on the open market.

Choice "c" is incorrect. The Fed should increase (not decrease) the required reserve ratio.

Choice "d" is incorrect. The Fed should increase (not decrease) the discount rate.

QUESTION 417 Which of the following correctly lists the three ways to increase the money supply?

A. Raise the required reserve ratio, increase the discount rate, sell bonds in the open market.

B. Raise the required reserve ratio, increase the discount rate, buy bonds in the open market.

C. Lower the required reserve ratio, increase the discount rate, buy bonds in the open market.

D. Lower the required reserve ratio, decrease the discount rate, buy bonds in the open market.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The three ways the Fed can increase the money supply are: (1) buy (purchase) government securities in the open market, (2) lower the discount rate, and (3) lower the required reserve ratio. Choice

"a" is incorrect, per Explanation above.

Choice "b" is incorrect, per Explanation above.

Choice "c" is incorrect, per Explanation above.

QUESTION 418 An increase in the money supply leads to:

A. A decline in interest rates, an increase in investment and an increase in aggregate demand.

B. A decline in interest rates, a decrease in investment and an increase in aggregate demand.

C. An increase in interest rates, a decrease in investment and a decrease in aggregate demand.

D. An increase in the money supply has no effect on interest rates or investment.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Expansionary monetary policy results when the Fed increases the money supply. Expansionary monetary policy affects the economy through the following chain of events: (1) an increase in the money supply causes interest rates to fall, (2) falling interest rates stimulate the desired levels of firm investment and household consumption, (3) increases in desired investment and consumption cause an increase in aggregate demand, and (4) aggregate demand shifts to the right causing real GDP and the price level to rise.

Choice "b" is incorrect. An increase in the money supply causes investment to increase, not decrease.

Choice "c" is incorrect. An increase in the money supply causes interest rates to decrease, not increase, investment to increase, not decrease and aggregate demand to increase, not decrease. Choice

"d" is incorrect per Explanation above.

QUESTION 419

Which of the following is most likely to cause an increase in the amount of frictional unemployment in an economy?

A. An invention that renders an industry obsolete.

B. A downturn in aggregate business activity.

- C. An increase in the average age of the work force.
- D. A reduction in the average age of the work force.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Younger workers tend to move between jobs more frequently.

Choice "a" is incorrect. This would lead to structural unemployment.

Choice "b" is incorrect. This would lead to cyclical unemployment.

Choice "c" is incorrect. Older workers tend to be voluntarily between jobs less frequently than younger workers.

QUESTION 420 Which of the following would lead to a reduction in inflation?

- A. Increasing aggregate demand and increasing aggregate supply.
- B. Decreasing aggregate demand and increasing aggregate supply.
- C. Decreasing aggregate demand and decreasing aggregate supply.
- D. Increasing aggregate demand and decreasing aggregate supply.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Decreasing aggregate demand and increasing aggregate supply will reduce the inflationary pressures.

Choice "a" is incorrect. Increasing aggregate demand causes the price level to rise.

Choice "c" is incorrect. Decreasing aggregate supply causes the price level to rise.

Choice "d" is incorrect. Both of these would cause the price level to rise.

QUESTION 421 Initially the nominal interest rate is 8 percent and the inflation rate is 6 percent. One year later, the nominal interest rate rises to 12 percent while the inflation rate rises to 10 percent. It follows that the real rate of interest:

- A. Has remained the same.
- B. Has fallen.
- C. Has risen.
- D. Insufficient information given for an answer.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The real interest rate equals the nominal interest rate minus the inflation rate. Thus, the real interest rate in the first year is: $\text{real interest rate} = 8 - 6 = 2$ and the real interest rate in the next year is: $\text{real interest rate} = 12 - 10 = 2$.

QUESTION 422

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.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

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

QUESTION 423 When a worker quits work to stay at home with the children, it is an example of:

- A. Frictional unemployment.
- B. Structural unemployment.
- C. Cyclical unemployment.
- D. Not counted in unemployment figures.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Unemployment only tallies workers actively seeking employment; it does not count retirees or stay-at-home parents.

Choice "a" is incorrect. Frictional unemployment describes workers who leave work voluntarily to seek a better position.

Choice "b" is incorrect. Structural unemployment describes workers whose skills are no longer needed.

Choice "c" is incorrect. Cyclical unemployment describes workers unemployed due to the business cycle.

QUESTION 424 The CPI jumps from 131 in year 1 to 136.5 in year 2. What is annual inflation rate?

- A. 4.2%
- B. 3%
- C. 1.38%
- D. 13.8%



Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The inflation rate is measured as:

$$\text{Inflation Rate} = \frac{\text{CPI}_{\text{this period}} - \text{CPI}_{\text{last period}}}{\text{CPI}_{\text{last period}}} \times 100$$

$$\text{Inflation Rate} = \frac{136.5 - 131}{131} \times 100 \approx 4.2\%$$

QUESTION 425 The

inflation rate measures:

- A. The rate at which nominal GDP increases.
- B. How the price of a particular good changes over time.
- C. How nominal interest rate changes over time.

D. The rate at which the overall price level increases.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The inflation rate measures the rate of increase in the overall price level in the economy.

Choice "a" is incorrect. The inflation rate is associated with price level changes not changes in the nominal value of output.

Choice "b" is incorrect. Inflation refers to a sustained increase in the overall price level. Not the price of a particular good. Choice

"c" is incorrect. The inflation rate is associated with price level changes not interest rate changes.

QUESTION 426

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.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Stagflation occurs when the economy suffers a recession that is characterized by falling output, rising unemployment, and a rising price level.

Choice "a" is incorrect. Real GDP is falling during stagflation, not rising.

Choice "c" is incorrect. High inflation rates is just one aspect of stagflation; the other is falling output and rising unemployment.

Choice "d" is incorrect. High unemployment rates are just one aspect of stagflation; the other is a rising overall price level (high inflation).

QUESTION 427 When the overall price level is rising, nominal interest rates tend to be:

A. Unaffected by changes in the price level.

B. Falling.

C. Rising.

D. None of the above.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The relationship between nominal interest rates and inflation can be seen by rearranging the equation for real interest rates as follows:

Nominal Interest Rate = Real Interest Rate + Inflation

Thus, if real interest rates do not change, a 1% increase in the inflation rate will lead to a 1% increase in nominal interest rates.

QUESTION 428 Inflation

can be caused by:

A. Increases in aggregate demand only.

B. Increases in aggregate supply only.

C. Decreases in aggregate demand and increases in aggregate supply.

D. Increases in aggregate demand and decreases in aggregate supply.

Correct Answer: D

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Both an increase in aggregate demand and a decrease in aggregate supply can cause inflation.

Choice "a" is incorrect. While an increase in aggregate demand can cause inflation, it is not the only cause of inflation.

Choice "b" is incorrect. An increase in aggregate supply would lower the overall price level, not increase the overall price level.

Choice "c" is incorrect. A decrease in aggregate demand would lower the overall price level, not increase the overall price level.

QUESTION 429

To address the problem of a recession, the Federal Reserve Bank most likely would take which of the following actions?

- A. Lower the discount rate it charges to banks for loans.
- B. Sell U.S. government bonds in open-market transactions.
- C. Increase the federal funds rate charged by banks when they borrow from one another.
- D. Increase the level of funds a bank is legally required to hold in reserve.

Correct Answer: A

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. During a recession, real GDP has fallen and unemployment has risen. To stimulate the economy, the Fed can lower the discount rate. This causes the money supply to increase, which, in turn, causes aggregate demand to shift right. As a result, real GDP would increase and unemployment would decrease.

Choice "b" is incorrect. If the Fed sells U.S. government bonds in the open market, the money supply will decrease. This causes aggregate demand to shift left. As a result, real GDP would decrease and unemployment would increase.

Choice "c" is incorrect. Increasing the federal funds rate would increase interest rates. Higher interest rates cause the aggregate demand curve to shift left. As a result, real GDP would decrease and unemployment would increase. Choice "d" is incorrect. An increase in the required reserve ratio causes the money supply to decrease.

This causes aggregate demand to shift left. As a result, real GDP would decrease and unemployment would increase.

QUESTION 430 Which of the following actions is the acknowledged preventive measure for a period of deflation?

- A. Increasing interest rates.
- B. Increasing the money supply.
- C. Decreasing interest rates.
- D. Decreasing the money supply.

Correct Answer: B

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Deflation is a general decline in the overall price level (i.e., when the inflation rate is negative). Increasing the money supply causes the overall price level to rise. As a result, it helps eliminate deflation.

Choice "a" is incorrect. Increasing interest rates causes aggregate demand to shift left. As a result, the aggregate price level will fall even further. This will exasperate deflation.

Choice "c" is not wrong but it is not as good an answer as "b". A decrease in interest rates causes the aggregate demand curve to shift right. As a result, the aggregate price level will rise. This helps eliminate deflation. However, there are times when interest rates are already so low that lowering interest rates is not an option. Thus, the preferred or "acknowledged" preventative measure for deflation is increasing the money supply. Choice "d" is incorrect. Decreasing the money supply causes the overall price level to fall. This would obviously exasperate deflation.

QUESTION 431

All of the following are components of the formula used to calculate gross domestic product, except:

- A. Household income.
- B. Foreign net export spending.
- C. Government spending.
- D. Gross investment.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Gross domestic product (GDP) is calculated in two different ways. The first, which is the expenditure approach and can be used to answer this question, is the mnemonic GICE, or government purchases plus private domestic investment plus personal consumption expenditures plus net exports. Household income is the only one of the answers that is not included in this mnemonic.

Choice "b" is incorrect. Foreign net export spending is included in the mnemonic (E) for GDP; although, it is called simply net exports in the mnemonic and not foreign net export spending.

Choice "c" is incorrect. Government spending is included in the mnemonic (G) for GDP.

Choice "d" is incorrect. Gross investment is included in the mnemonic (I) for GDP, although it is called private domestic investment in the mnemonic.

QUESTION 432 Gross domestic product includes which of the following measures?

- A. The size of a population that must share a given output within one year.
- B. The negative externalities of the production process of a nation within one year.
- C. The total monetary value of all final goods and services produced within a nation in one year.
- D. The total monetary value of goods and services including barter transactions within a nation in one year.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Gross domestic product (GDP) is the total dollar (monetary) value of all new final products and services produced with the economy in a given time period. The emphasis is on the final goods and services.

Choice "a" is incorrect. The size of a population that must share a given output within one year is not a part of the GDP calculation.

Choice "b" is incorrect. The negative (or positive) externalities of the production process of a nation within one year are not a part of the GDP calculation. In economics, externalities are the effects that the acts of consumers or producers have on each other. Externalities range from technological changes to changes in the range of options available to consumers. Externalities may also be regarded as the unanticipated side effects of courses of action. Choice "d" is incorrect. The total monetary value of goods and services, including barter transactions, is not a part of the GDP calculation. GDP includes only monetary value, not barter value.

QUESTION 433

Which of the following is correct regarding the consumer price index (CPI) for measuring the estimated decrease in a company's buying power?

- A. The CPI is measured only once every 10 years.
- B. The products a company buys should differ from what a consumer buys.
- C. The CPI measures what consumers will pay for items.
- D. The CPI is skewed by foreign currency translations.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The consumer price index measures the costs of a market basket of specific goods commonly purchased by consumers. It measures consumer buying power and is not distorted by items generally bought by industry.

Choice "a" is incorrect. The Consumer Price Index (CPI) represents monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services. Choice "c" is incorrect. The Consumer Price Index measures what has been paid for items, not what consumers will pay for items.

Choice "d" is incorrect. The Consumer Price Index measures what has been paid by consumers in over eighty urban areas in the United States. The amounts paid are denominated in US dollars and would not be skewed by foreign currency translations.

QUESTION 434

The following table contains Emerald Corp.'s quarterly revenues, in thousands, for the past three years. During that time, there were no major changes to Emerald's selling strategies and total capital investment.

<u>Year</u>	<u>1st Qtr.</u>	<u>2nd Qtr.</u>	<u>3rd Qtr.</u>	<u>4th Qtr.</u>
Year 1	500	500	550	750
Year 2	525	550	600	800
Year 3	550	525	625	850

Which of the following statements best describes the likely cause of the fluctuations in Emerald's revenues and the best response to those fluctuations?

- A. The fluctuations are from changes in the economy, and Emerald should examine its cost structure for potential changes.
- B. The fluctuations are from changes in the economy, and Emerald should manage its inventories and cash flow to match the cycle.
- C. The fluctuations are from the seasonal demand for Emerald's products, and Emerald should examine its cost structure for potential changes.
- D. The fluctuations are from the seasonal demand for Emerald's products, and Emerald should manage its inventories and cash flow to match the cycle.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Relatively stable demand over a three year period in each of the first three quarters of the year followed by an increase of between 40 and 50 percent in the final quarter of the year over average sales in the first three quarters in each of the three years presented is indicative of seasonal fluctuations in demand for Emerald's product that would require appropriate inventory management.

Choice "a" is incorrect. The consistent volume levels and fluctuation percentages displayed for the activity in each quarter for each year are indicative of changes in seasonal demand rather than changes in the economy generally.

Choice "b" is incorrect. The consistent volume levels and fluctuation percentages displayed for the activity in each quarter for each year are indicative of changes in seasonal demand rather than changes in the economy generally.

Choice "c" is incorrect. Relatively stable demand over a three year period in each of the first three quarters of the year followed by an increase of between 40 and 50 percent in the final quarter of the year over average sales in the first three quarters in each of the three years presented is indicative of seasonal fluctuations in demand for Emerald's product. The company should be more attentive to the timing of inventory purchases to meet demand, however, rather than the company's overall cost structure.

QUESTION 435 When markets are perfectly competitive, consumers:

- A. Have goods and services produced at the lowest cost in the long run.
- B. Must choose the brands they buy solely on the basis of informational advertising.
- C. Do not receive any consumer surplus unless producers choose to overproduce.
- D. Must search for the lowest price for the products they buy.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Since price is barely sufficient to give a firm a normal profit and stay in business, the consumer obtains the product at as low a price as is economically feasible. In addition, every firm is forced to produce at the most efficient output rate.

Choice "b" is incorrect. Brand differentiation is present in monopolistic competition, not perfect competition.

Choice "c" is incorrect. This is a far-out distractor.

Choice "d" is incorrect. Also far out. Individual consumers are also price takers at the market equilibrium price.

QUESTION 436

Which one of the following is not a key assumption of perfect competition?

- A. Customers are indifferent about which firm they buy from.
- B. The level of a firm's output is small relative to the industry's total output.
- C. Each firm can price its product above the industry price.
- D. There is freedom of entry into and exit out of the industry.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A key assumption of perfect competition is that the firm is a "price taker," that is, it cannot fix the price. Accordingly, it is not true that each firm can price its product above the industry price. Key assumptions of perfect competition include:

- A. Customers are indifferent about which firm they buy from.
- B. The level of a firm's output is small relative to the industry's total output.
- D. There is freedom of entry into and exit out of the industry.

QUESTION 437 In order to sell at the rate of output in markets controlled by monopolists, price is set where:

- A. Price equals marginal cost.
- B. Marginal revenue equals marginal cost.
- C. Marginal revenue equals average total cost.
- D. Price equals average total cost.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. In order to sell at the rate of output in markets controlled by monopolists, the price is set where marginal revenue equals marginal cost. No matter which model is representative of the industry in which the firm operates, the firm will maximize profits by producing at $MR = MC$. The monopolist's price will be higher than MR.

Choice "a" is incorrect. Price exceeds both MR and MC.

Choices "c" and "d" are incorrect, which are far-out distractors.

QUESTION 438 A natural monopoly exists because:

- A. The firm owns natural resources.
- B. Economic and technical conditions permit only one efficient supplier.
- C. The government is the only supplier.
- D. Other firms are unable to enter the industry.



Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A natural monopoly exists when economic and technical conditions permit only one efficient supplier. Choice "a" is incorrect. Owning natural resources, even if they are unique, would not create a monopoly.

Substitutes for the resource may be available.

Choice "c" is incorrect. Government control may create a monopoly, but not a natural monopoly. This is a regulated monopoly. Choice

"d" is incorrect. Barriers to entry help create a monopoly, but the product must be unique.

QUESTION 439 Which one of the following statements concerning pure monopolies is correct?

- A. The demand curve of a monopolist is perfectly elastic.
- B. The price at which a monopolist maximizes its profit is where price equals both marginal cost and marginal revenue.
- C. A monopolist's marginal revenue curve lies below its demand curve.
- D. The supply curve of a monopolist is perfectly inelastic.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A monopolist's marginal revenue curve lies below its demand curve.

Choice "a" is incorrect. The demand curve of a monopolist is not perfectly elastic.

Choice "b" is incorrect. A monopolist sets its price higher than marginal revenue.

Choice "d" is incorrect. A monopolist can change the quantity supplied or fix the price but cannot do both simultaneously. In any case, its supply curve is not perfectly inelastic.

QUESTION 440

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.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

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 441 Entry into monopolistic competition is:

- A. Frequent, as no obstacles exist.
- B. Difficult, with significant obstacles.
- C. Rare, as significant capital is required.
- D. Relatively easy, with only a few obstacles.



Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The characteristics of monopolistic competition include:

- Numerous firms with differentiated products.
- Ease of entry - few barriers.
- Firms exert some influence over price and market.
- Non-price competition is frequent and critical.

Choice "a" is incorrect. Monopolistic competition has a few obstacles. A market with no obstacles is in perfect competition.

Choice "b" is incorrect. Significant obstacles are characteristic of oligopoly.

Choice "c" is incorrect. Significant capital requirements represent a significant barrier to entry, which is characteristic of oligopoly.

QUESTION 442

In markets that are imperfectly competitive, such as monopoly and monopolistic competition, firms produce at an output where:

- A. Price equals marginal cost.
- B. Average costs are minimized.
- C. Price equals average cost.
- D. Marginal cost equals marginal revenue.

Correct Answer: D

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "d" is correct. Firms produce up to the point where marginal cost equals marginal revenue, whether the markets are perfectly competitive or imperfectly competitive.

Choice "a" is incorrect. Very close, but it's actual marginal revenue, not price. It is assumed that revenue is not fixed on a unit basis.

Choice "b" is incorrect. Beyond the point of average costs being minimized, marginal cost will rise. Still, it will make sense to increase production until marginal cost equals marginal revenue.

Choice "c" is incorrect. Marginal revenue, not price, as revenue is assumed to vary on a per unit basis, and not average cost, since it will increase profits to expand production until marginal revenue equals marginal cost.

QUESTION 443 Monopolistic competition is characterized by:

- A. A relatively large group of sellers who produce differentiated products.
- B. A relatively small group of sellers who produce differentiated products.
- C. One or two companies producing similar products.
- D. A relatively large group of sellers who produce a homogeneous product.

Correct Answer: A

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "a" is correct. Monopolistic competition is characterized by a relatively large number of sellers who produce differentiated products. There are few barriers to entry and firms exert some influence over the price and the market. Best examples are brand name consumer products.

Choice "b" is incorrect. Relatively few sellers with differentiated products would indicate an oligopoly.

Choice "c" is incorrect. One company would be a monopoly, two - an oligopoly.

Choice "d" is incorrect. A relatively large number of sellers and a standardized product indicates perfect competition.

QUESTION 444 An industry that is oligopolistic would be best characterized by:

- A. One firm selling a product with no close substitutes.
- B. Significant barriers to entry.
- C. Horizontal or flat demand curves for the output of individual firms.
- D. The absence of significant economies of scale.

Correct Answer: B

Section: Business Environment and Concept**Explanation****Explanation/Reference:**

Explanation:

Choice "b" is correct. Oligopoly market conditions are characterized by:

- Few firms in the market
- Significant barriers to entry
- Differentiated products
- Fixed (or semi fixed) prices
- Kinked demand curves

Choice "a" is incorrect. This is an example of monopoly.

Choice "c" is incorrect. Horizontal demand curves represent demand that is perfectly price elastic (buyers will only pay one price for any quantity of a product). This occurs in perfectly competitive markets. Choice "d" is incorrect. This is characteristic of perfect competition, as there are no barriers to entry ("size doesn't matter") in perfect competition.

QUESTION 445 The kinked demand curve is associated with:

- A. The analysis of agricultural markets.

- B. The analysis of monopolistic competition.
- C. The analysis of pure competition.
- D. The analysis of oligopoly.

Correct Answer: D

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The demand curve for any individual oligopolist is kinked sharply downward. This occurs because, in oligopoly market conditions, the other firms in the market will match any price reduction so they do not lose market share but will not match any price increase of an individual firm.

Therefore, for the individual firm attempting to raise its prices beyond equilibrium, consumers will quickly buy from other firms in the market and demand will drop off sharply creating a kinked demand curve. Choices "a", "b", and "c" are incorrect, per the explanation above.

QUESTION 446

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 market structure Karen Parker is attempting to enter is best described as:

- A. Pure competition.
- B. A natural monopoly.
- C. An oligopoly.
- D. Monopolistic competition.

Correct Answer: C

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Major competitors and substantial capital requirements (high barriers to entry) are oligopolistic market conditions.

Choice "a" is incorrect. Pure competition has small barriers to entry and numerous suppliers.

Choice "b" is incorrect. A natural monopoly suggests that economic conditions allow only one supplier for efficiency purposes.

Choice "d" is incorrect. Monopolistic competition has easier barriers to entry and more firms competing to supply the market than oligopoly.

QUESTION 447 Any business firm that has the ability to control the price of the product it sells:

- A. Faces a downward-sloping demand curve.
- B. Does not have any entry or exit barriers in its industry.
- C. Has a supply curve that is horizontal.
- D. Has a demand curve that is horizontal.

Correct Answer: A

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Any business firm that has the ability to control the price of the product it sells faces a downward-sloping demand curve for the firm. Only the firm in a competitive market is a price-taker facing a horizontal demand curve at the market equilibrium price.

Choice "b" is incorrect. Firms in competitive industries have no entry or exit barriers and are price-takers.

Choice "c" is incorrect, this is a far-out distractor.

Choice "d" is incorrect. Only firms in perfectly competitive markets (price-takers) face horizontal demand curves.

QUESTION 448 If a group of consumers decide to boycott a particular product, the expected result would be:

- A. An increase in the product price to make up lost revenue.
- B. A decrease in the demand for the product.
- C. An increase in product supply because of increased availability.
- D. That companies in the industry would experience higher economic profits.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A consumer boycott will decrease demand for the product being boycotted.

Choice "a" is incorrect. Increasing price will further reduce the quantity demanded. The effect on revenue is uncertain.

Choice "c" is incorrect. Supply will be unaffected by a boycott.

Choice "d" is incorrect. A boycott of a particular product will reduce the overall profits of the industry.

QUESTION 449 In competitive markets, an increase in an effective minimum wage will:

- A. Have a neutral effect on the demand for labor.
- B. Decrease the supply of labor.
- C. Decrease unemployment.
- D. Increase unemployment.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When the "minimum" wages are increased, employers may elect to hire fewer employees thereby increasing unemployment. Choice

"a" is incorrect. An increase in the minimum wage will have an effect on the demand for labor.

Choice "b" is incorrect. The supply of labor will likely go up as the wage being paid increases. Choice

"c" is incorrect. As the minimum wage increases, unemployment will increase.

QUESTION 450 In a competitive market, an increase in the minimum wage will likely have the following effects:

- A. Firms currently paying above the new minimum wage would generally raise their pay rates (although the new minimum wage creates a new floor for employee wage bargaining purposes).
- B. Firms paying at the current minimum wage rate would generally be unaffected if the marginal revenue produced by the lowest paid workers does not exceed the new higher cost of the worker. Many firms would thus be forced to work more efficiently.
- C. Total employment will likely decrease in affected industries and generate unemployment. Employers will demand a smaller number of workers while a larger number of workers will be attracted by the higher wage.
- D. If a marginally more expensive form of capital is available to substitute for labor (e.g., due to technological advances), firms will reduce their use of labor.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. With an increase in the minimum wage, total employment will likely decrease in affected industries and generate unemployment. Employers will demand a smaller number of workers while a larger number of workers will be attracted by the higher wage.

Choice "a" is incorrect. Firms currently paying above the new minimum wage would generally be unaffected, not raise their pay rates.

Choice "b" is incorrect. Firms paying at the current minimum wage rate would attempt to reduce labor, not generally be unaffected. Choice

"d" is incorrect. If a marginally cheaper, not more expensive.

QUESTION 451 Suppose the equilibrium wage for low skilled workers in California is \$6.00 an hour. If the government increases the minimum wage to \$7.00 an hour, what would be the effect on the market for low skilled labor?

- A. An excess demand for labor would result.
- B. An excess supply of labor would result.
- C. The demand for labor would decrease.
- D. The supply of labor would increase.

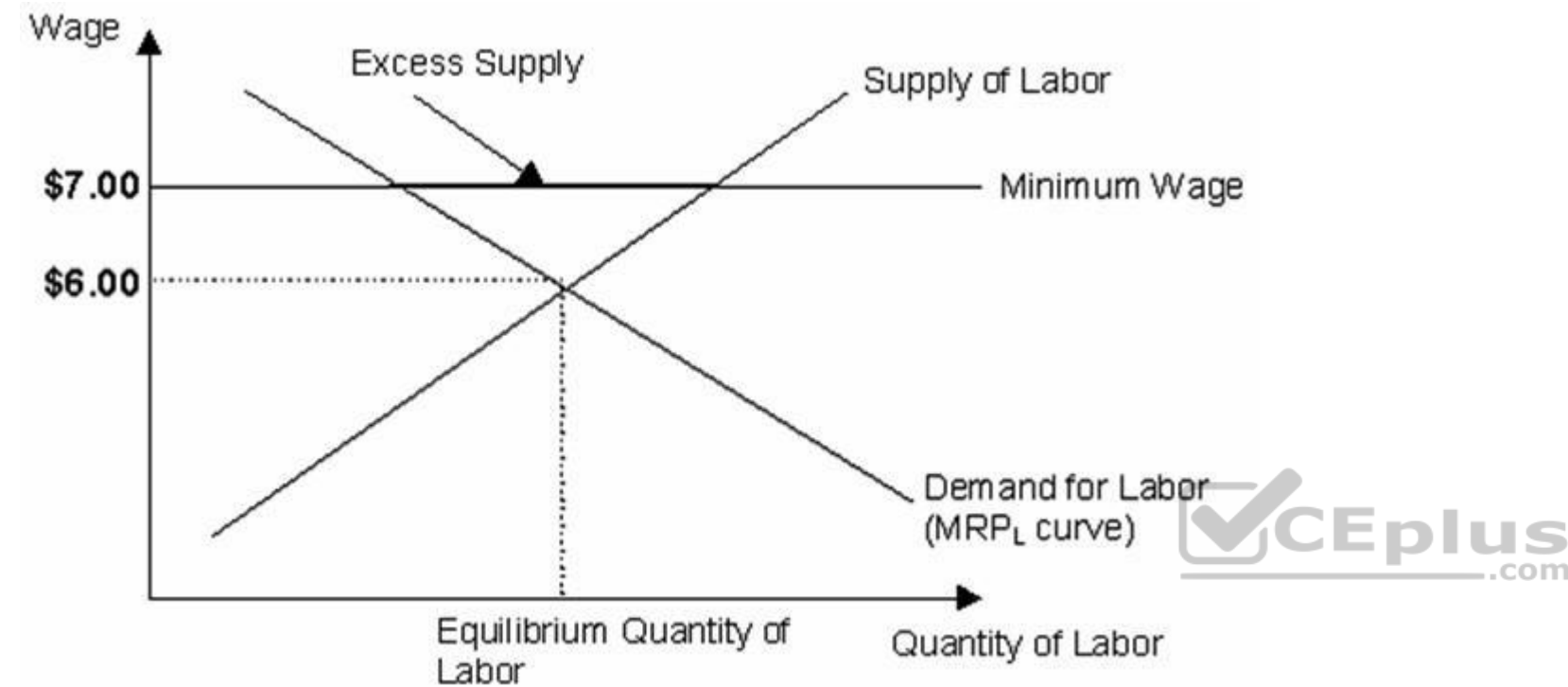
Correct Answer: B

Section: Business Environment and Concept Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. A minimum wage that is set above the equilibrium wage will result in an excess supply (or surplus) of labor.



Choice "a" is incorrect, since the quantity demanded of labor at \$7 is less than the quantity supplied, implying an excess supply not an excess demand.

Choice "c" is incorrect. An increase in the minimum wage causes a decrease in quantity demanded of labor, not a decrease in the demand (shift in demand) for labor. Choice "d" is incorrect, per the above Explanation: .

QUESTION 452

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

- A decrease in the quantity demanded of labor.
- B. An increase in the quantity supplied of labor.
- C. A decrease in total employment.
- D. All of the above.

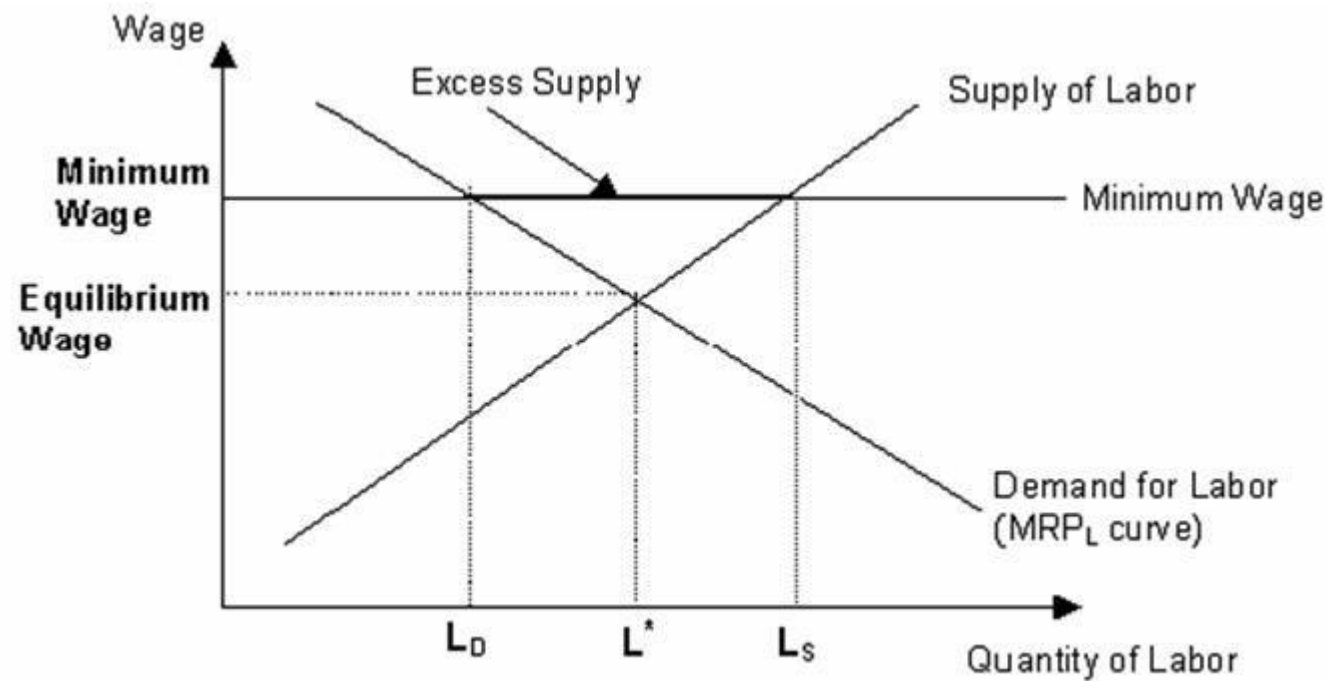
Correct Answer: D

Section: Business Environment and Concept Explanation

Explanation/Reference:

Explanation:

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



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

QUESTION 453

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?



Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Although the firm needs to be flexible with respect to changes in many situations and then adapt to them, the ability to adapt to the preferences of its employees is not nearly as significant to the process as the other three choices, which are crucial to the success of the strategic plan.

Choices "a", "b", and "c" are incorrect because they are all significant questions a firm should be concerned with when re-evaluating the strategic plan.

QUESTION 454 Under monopolistic competition, strategic plans focus on:

- A. Profitability from production levels that maximize profits.
- B. Maintaining the market share and being responsive to market conditions related to sales price.
- C. Maintaining the market share and planning for enhanced product differentiation.
- D. Maintaining the market share, ensuring product differentiation, and adapting to price changes or required changes in production volume.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Under monopolistic competition, strategic plans include maintaining the market share (as with pure competition), but they also likely include plans for enhanced product differentiation and allocation of resources to advertising, product research, etc.

Choices "a", "b", and "d" are incorrect because they are characteristics of other types of market structures.

QUESTION 455 Under monopoly, strategic plans focus on:

- A. Profitability from production levels that maximize profits.
- B. Maintaining the market share and being responsive to market conditions related to sales price.
- C. Maintaining the market share and planning for enhanced product differentiation.
- D. Maintaining the market share, ensuring product differentiation, and adapting to price changes or required changes in production volume.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Under monopoly, strategic plans ignore market share and focus on profitability from production levels that will maximize profits. Choices "b", "c", and "d" are incorrect because they are characteristics of other types of market structures.

QUESTION 456 With respect to price elasticity of demand:

- A. The shorter the time period, the more product demand becomes elastic because less choices are available.
- B. Product demand is more elastic when fewer substitutes are available.
- C. Product demand is more inelastic when more substitutes are available.
- D. Product demand is more elastic when more substitutes are available.

Correct Answer: D

Section: Business Environment and Concept

Explanation



Explanation/Reference:

Explanation:

Choice "d" is correct. Product demand is more elastic when more substitutes are available.

Choice "a" is incorrect. The longer the time period, the more product demand becomes elastic because more choices are available.

Choice "b" is incorrect. Product demand is more elastic when more substitutes are available, not fewer substitutes. Choice "c" is incorrect. Product demand is more inelastic when few substitutes are available.

QUESTION 457 If demand is price inelastic:

- A. An increase in price will result in a decrease in total revenue.
- B. An increase in price will result in an increase the quantity demanded that is more than the increase in price.
- C. An increase in price will result in an increase in total revenue.
- D. An increase in price will have no effect on total revenue.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. If demand is price inelastic, an increase in price will result in an increase in total revenue (positive relationship).

Choice "b" is incorrect. When demand is price inelastic, an increase in price results in a decrease in quantity demanded that is proportionately smaller than the increase in price, thus having the result of an increase in total revenue (price multiplied by quantity).

Choices "a" and "d" are incorrect, per the above statement.

QUESTION 458 If demand is price elastic:

- A. An increase in price will result in a decline in total revenue.
- B. An increase in price will result in a decline the quantity demanded that is less than the increase in price.
- C. An increase in price will result in an increase in total revenue.
- D. An increase in price will have no effect on total revenue.

Correct Answer: A

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. If demand is price elastic, an increase in price will result in a decline in total revenue (negative relationship).

Choice "b" is incorrect. When demand is price elastic, an increase in price results in a decline in quantity demanded that is proportionately larger than the increase in price, thus having the result of a decline in total revenue (price multiplied by quantity).

Choices "c" and "d" are incorrect, per the above statement.

QUESTION 459 If demand is unit elastic:

- A. An increase in price will result in a decline in total revenue.
- B. An increase in price will result in a decline the quantity demanded that is less than the increase in price.
- C. An increase in price will result in an increase in total revenue.
- D. An increase in price will have no effect on total revenue.

Correct Answer: D

Section: Business Environment and Concept
Explanation



Explanation/Reference:

Explanation:

Choice "d" is correct. If demand is unit elastic, a change in price will have no effect on total revenue. Choices

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

QUESTION 460 Which of the following is incorrect with regard to government intervention in market operations?

- A. Government intervention may create a price different from the market price, thus causing either a surplus or a shortage.
- B. A price ceiling is a price that is established above the equilibrium price, which causes a surplus to develop.
- C. Price floors are minimum prices established by law, such as minimum wages and agricultural price supports.
- D. Rationing limits the availability of certain goods to a specified level, which lowers demand and prices for a given supply.

Correct Answer: B

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "b" is an incorrect statement and the correct choice. A price ceiling is a price that is established below the equilibrium price, which causes a shortage to develop. The statement in choice "b" defines a price floor. Choices

"a", "c", and "d" are correct statements.

QUESTION 461 Which of the following is incorrect with regard to value chain analysis?

- A. Value chain analysis must be used in conjunction with the strategic plan of the organization.
- B. Value chain analysis is critical to assessing the competitive advantage of a firm.

- C. Value chain analysis is a strategic tool that assists the firm in determining how important the perceived value of the buyers is with respect to the market the firm operates in.
- D. The value chain starts with the firm and goes all the way through to the end users of the product.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is an incorrect statement and the correct choice. The best description of a value chain is that value starts with the suppliers who provide the raw materials for a production process, continues with the firm and its strategic plan, continues with the value created by the customers, and then ends with the disposal and recycling of the materials. Choices "a", "b", and "c" are incorrect, as all are correct statements with regard to value chain analysis.

QUESTION 462

According to Michael Porter, which of the following are the two major categories of business activities?

- A. Demand activities and supply activities.
- B. Firm activities and customer activities.
- C. Primary activities and support activities.
- D. Internal activities and external activities.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. According to Michael Porter, the two major categories of business activities are primary activities and support activities. Choices "a", "b", and "d" are incorrect, per the above statement.



QUESTION 463 Which of the following activities is considered a support activity?

- A. Delivery of products.
- B. Procurement of materials.
- C. Product advertising.
- D. In-home warranty service.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Support activities are those activities that are performed by the support staff of an organization (e.g., purchasing of materials and supplies, development of the technology used, management of employees, accounting, finance, strategic planning, etc.).

Choices "a", "c", and "d" are incorrect, as these are all considered primary activities. Primary activities are those that are involved with the direct manufacture of products, the delivery of products through distribution channels, and the support of the product that exists after the sale is made (e.g., handling the raw materials, the manufacturing process, taking orders for the product, advertising the product, and servicing the product after it is sold).

QUESTION 464

When applying value chain analysis, a firm sends its production manager to visit the operations of its major supplier in an attempt to determine if there are cost-savings capabilities that could be implemented at the supplier's warehouse. The firm is performing which form of value chain analysis?

- A. Internal differentiation analysis.
- B. Internal costs analysis.
- C. Vertical linkage analysis.
- D. None of the above.

Correct Answer: C

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Analyzing the vertical linkage of a firm means understanding the activities of the suppliers and buyers of the product and determining where value can be created external to the firm's operations. Choices "a", "b", and "d" are incorrect, per the above Explanation: .

QUESTION 465

Which of the following is not a type of major strategic framework that has proven useful for value chain analysis?

- A. Core competencies analysis.
- B. Customer preference analysis.
- C. Industry structure analysis.
- D. Segmentation analysis.

Correct Answer: B

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Customer preference analysis is not a major strategic framework that has been proven to be useful for value chain analysis.

Choices "a", "c", and "d" are incorrect, as the three major types of strategic frameworks that have been proven to be useful for value chain analysis are industry structure analysis, core competencies analysis, and segmentation analysis.

QUESTION 466

Jordan 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, Jordan's management has implemented a strategic framework that focuses on why the firm has been so successful in its market. Jordan Industries has implemented which type of strategic framework?

- A. Industry structure analysis.
- B. Core competencies analysis.
- C. Segmentation analysis.
- D. None of the above.

Correct Answer: B

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Analysis of the core competencies of a firm help it to determine why it is able to create, attain, and sustain new types of competitive advantage and profits and reveal what it is within the firm that enables it to obtain competitive advantage.

Choice "a" is incorrect. Industry structure analysis assists in determining what it is that makes a firm more profitable compared to another firm, and it looks at five forces that influence profitability of an industry or market and, thus, the competitive environment.

Choice "c" is incorrect. Segmentation analysis is a possibility when a firm is vertically integrated and when the industry structure and core competencies vary among activities in the value chain. Choice "d" is incorrect, as choice "b" is the answer to the question.

QUESTION 467

If a nation has superior conditions in which to grow coffee beans and firms are able to grow them at very low costs, which of the four major factors that Michael Porter has indicated impact the global competitive environment would allow this nation to fare better with respect to global competitive advantage?

- A. Conditions of the factors of production.
- B. Conditions of domestic demand.
- C. Related and supporting industries.
- D. Firm strategy, structure, and rivalry.

Correct Answer: A

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. If a nation has a strong set of factors of production (such as low cost, high quality raw material inputs), that are required in a given industry, it will fare better with regard to competitive advantage.

Choice "b" is incorrect. Conditions of domestic demand relate to the nation's domestic demand for the product, which is directly related to the ability of the nation to fare better with regard to competitive advantage.

Choice "c" is incorrect. The factor of related and supporting industries deals with whether there are suppliers of material inputs that exist within a nation or whether there are rival firms who are competitive in the international environment, both of which would increase the nation's competitive advantage.

Choice "d" is incorrect. The factor of firm strategy, structure, and rivalry relates to the practices of a nation with respect to how the companies are managed and organized, long with the laws of the nation that regulate the formation of the companies, and how intense the rivalry is with respect to competing firms in the nation.

QUESTION 468

Factors internal to the organization that impact strategy and are sources of strengths and weaknesses include all of the following, except:

- A. Marketing effectiveness.
- B. Competence of management.
- C. Innovation of product lines.
- D. Regulations and laws.

Correct Answer: D

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Regulations and laws are external factors of opportunities and threats that affect the overall industry. Choices

"a", "b", and "c" are incorrect, as all of these factors are examples of internal factors of an organization.

QUESTION 469 When does competition not become an even stronger force impacting the profitability of a firm?

- A. The market consists of several equal-sized firms.
- B. Customers do not have strong brand preferences.
- C. The market is fast-growing.
- D. The costs of exiting the market exceed the costs of continuing to operate.

Correct Answer: C

Section: Business Environment and Concept
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct, as it is not a factor that would cause market competitiveness to be even stronger.

Choices "a", "b", and "d" are incorrect because they are all reasons that competition becomes an even stronger force that impacts the firm's profitability. The following are situations that would cause competition to be an even stronger force impacting the profitability of a firm:

- The market is not growing fast.
- There are several equal-sized firms in the market.
- Customers do not have strong brand preferences.
- The costs of exiting the market exceed the costs of continuing to operate.
- Some firms profit from making certain moves to increase market share.
- The various firms in the market use different types of strategic plans.

QUESTION 470 Which of the following statements regarding the existence of substitute products is correct?

- A. The impact of substitutes will have more of an effect on the competitive environment of a firm if the substitutes are difficult for customers to obtain.
- B. When the cost of buyers switching to new products is high, the effect of substitutes on the competitive environment of a firm is high.

- C. If few substitutes exist, buyers have little choice of products and may be willing to pay a higher price for the products that are available.
- D. If few substitutes exist, buyers may have a limit on the maximum price that they are willing to pay and may choose to not purchase the firm's product if the price is too high.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. If few substitutes exist, buyers have little choice of products and may be willing to pay a higher price for the products that are available.

Choice "a" is incorrect. The impact of substitutes will have more of an effect on the competitive environment of a firm if the substitutes are readily available to consumers (not difficult to obtain).

Choice "b" is incorrect. When the cost of buyers switching to new products is low (not high), the effect of substitutes on the competitive environment of a firm is high.

Choice "d" is incorrect. If many (not few) substitutes exist, buyers may have a limit on the maximum price that they are willing to pay and may choose to not purchase the firm's product if the price is too high.

QUESTION 471 Which of the following is not considered a factor that increases the bargaining power of the customer?

- A. Much information is available to the customer to compare and contrast features of all products on the market.
- B. One group of customers makes up a large volume of the firm's business.
- C. Buyers have low switching costs of changing products.
- D. The firm is unable to change suppliers easily.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When a firm is unable to change suppliers easily, that is a factor that increases the bargaining power of the suppliers.

Choices "a", "b", and "c" are incorrect because they all are factors that increase the bargaining power of the customer, which are:

- Customers make up a large volume of a firm's business.
- There is much information available to customers.
- The buyers have low switching costs.
- There are a high number of alternate suppliers.

QUESTION 472 When do cost leadership strategies fail?

- A. Buyers have large amounts of bargaining power in the market.
- B. Heavy price competition exists in the market.
- C. Buyers become less price sensitive and start to have brand loyalty.
- D. New entry firms are able to influence buyers to switch to their product by cutting the price of their product for a period of time in an effort to gain market share and increase profits.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. If firms overlook the fact that few customers care about the fact that a product is priced lower than others and care more about brand loyalty, cost leadership strategies will fail. Choices

"a", "b", and "d" are incorrect, as these are all situations in which cost leadership strategies work well.

QUESTION 473 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.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct because it is not a correct statement. The best cost strategy strives to have the firm evaluate and change its value chain such that it can achieve the lowest (not highest) cost among its closest competitors while matching them on the features desired by consumers.

Choices "a", "b", and "c" are incorrect, as they are all true statements regarding best cost provider strategies.

QUESTION 474 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.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The "deliver" process encompasses all the activities of getting the finished product into the hands of the ultimate consumers to meet their planned demand. Managing accounts receivable and collections from customers falls into the "deliver" process.

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

QUESTION 475 Considering the SCOR Model of supply chain operations, which of the following key management processes does assessing the ability of the suppliers to supply resources fall into?

- A. Plan.
- B. Source.
- C. Make.
- D. Deliver.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The process of planning consists of developing a way to properly balance aggregate demand and aggregate supply within the goals and objectives of the firm and plan for the necessary infrastructure. Assessing the ability of the suppliers to supply resources is part of the "plan" process. Choices "b", "c", and "d" are incorrect, per the above Explanation: .

QUESTION 476 Considering the SCOR Model of supply chain operations, which of the following key management processes does implementing changes in engineering fall into? A. Plan.

- B. Source.
- C. Make.
- D. Deliver.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The "make" process encompasses all the activities that turn the raw materials into finished products that are produced to meet a planned demand. Implementing changes in the engineering process falls into the "make" process.

Choices "a", "b", and "d" are incorrect, per the above Explanation: .

QUESTION 477 Considering the SCOR Model of supply chain operations, which of the following key management processes does collecting and processing vendor payments fall into?

- A. Plan.
- B. Source.
- C. Make.
- D. Deliver.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Once demand has been planned, it is necessary to procure the resources required to meet it and to manage the infrastructure that exists for the sources. Collecting and processing vendor payments falls into the "source" process.

Choices "a", "c", and "d" are incorrect, per the above Explanation: .

QUESTION 478

In which stage of supply chain management will management move away from simple consolidation of its operations to an internally-integrated supply chain, which all work together towards the main business issue of the cost of customer service?

- A. Cross-functional teams.
- B. Integrated enterprise.
- C. Extended supply chain.
- D. Supply chain communities.



Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. In the integrated enterprise stage of supply chain management, the firm's management will move away from simple consolidation of its operations to an internally-integrated supply chain, which all work together towards the main business issue of the cost of customer service.

Choice "a" is incorrect. In the cross-functional teams stage of supply chain management, the firm's management will turn its attention to consolidation of the various departments that make up operations in order to solve the firm's problems, and the focus will be on customer service.

Choice "c" is incorrect. In the extended supply chain stage of supply chain management, integration moves external to the firm to involve those outside the firm who are able to work as a unified team in an attempt to obtain slow, profitable growth.

Choice "d" is incorrect. In the supply chain communities stage of supply chain management, the extended supply chain forms a single competitive entity with a synchronized supply chain and a complex system of networks.

QUESTION 479 In which stage of supply chain management will integration move external to the firm to involve those outside the firm who are able to work as a unified team in an attempt to obtain slow, profitable growth? A. Cross-functional teams.

- B. Integrated enterprise.
- C. Extended supply chain.
- D. Supply chain communities.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. In the extended supply chain stage of supply chain management, integration moves external to the firm to involve those outside the firm who are able to work as a unified team in an attempt to obtain slow, profitable growth.

Choice "a" is incorrect. In the cross-functional teams stage of supply chain management, the firm's management will turn its attention to consolidation of the various departments that make up operations in order to solve the firm's problems, and the focus will be on customer service.

Choice "b" is incorrect. In the integrated enterprise stage of supply chain management, the firm's management will move away from simple consolidation of its operations to an internally-integrated supply chain, which all work together towards the main business issue of the cost of customer service.

Choice "d" is incorrect. In the supply chain communities stage of supply chain management, the extended supply chain forms a single competitive entity with a synchronized supply chain and a complex system of networks.

QUESTION 480 An increase in the quantity demanded for a product would be associated with a(n):

- A. Increase in the price of a complementary product.
- B. Increase in average household income.
- C. Decrease in the price of that product.
- D. Decrease in the price of a substitute product.

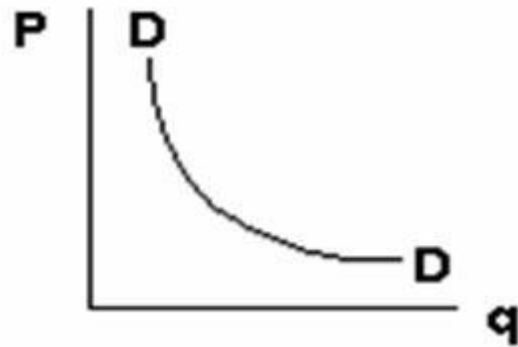
Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:



Choice "c" is correct. The fundamental law of demand holds that there is an inverse relationship between price of the product and the quantity demanded. We move along the demand curve D-D.

Choice "a" is incorrect. An increase in complementary product prices would decrease the demand curve (e.g., if PC prices increase, the demand for printers and other peripherals decrease). Choice

"b" is incorrect. Increases in consumers and consumer income shift the demand curve itself.

Choice "d" is incorrect. A decrease in price for a substitute product (like Pepsi) decreases demand for the other product (Coke).

QUESTION 481 An increase in the market supply of beef would result in a(n):

- A. Decrease in the quantity of beef demanded.
- B. Increase in the price of beef.
- C. Decrease in the demand for beef.
- D. Increase in the quantity of beef demanded.

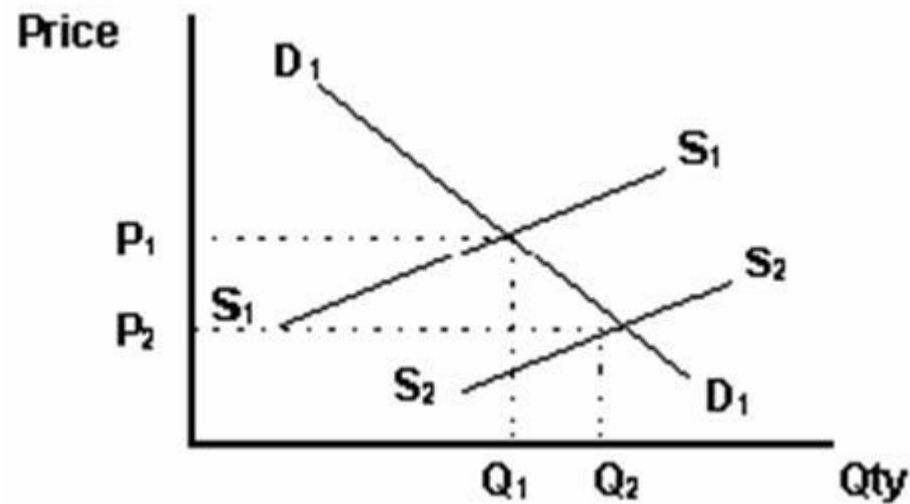
Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:



Choice "d" is correct. As illustrated above, a shift outward (increase) in supply, increases quantity demanded (Q_2) at equilibrium, accompanied by a decline in price. Thus, an increase in the market supply of beef would result in an increase in the quantity of beef demanded.

Choices "a" and "b" are incorrect, as seen in the graph above. There is an increase in the quantity of beef demanded and a decrease in the price of beef.

Choice "c" is incorrect, because there is no information in the question pertaining to any "shift" in the beef demand curve or in the demand for any complimentary products (e.g., pork).

QUESTION 482 In competitive markets, an increase in demand for a product causes a(n):

- A. Increase in product supply.
- B. Reduction in purchases by consumers.
- C. Reduction in the number of buyers of the product.
- D. Increase in the price of the product.

Correct Answer: D

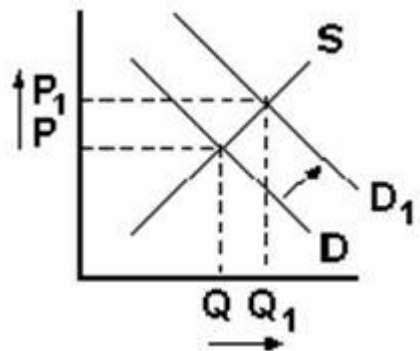
Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Rule of economic reasoning: "Draw the graph!"



Choice "d" is correct. When demand increases and supply has not increased (as implied by the question), suppliers will raise the price of the product and more product will be bought (but the supply curve does not change). Because consumers are demanding more product than is available, they are "willing" to pay a higher price.

Choice "a" is incorrect. Although buyers would pay higher prices and purchase more products, the supply "curve" has not changed. Therefore, the quantity supplied remains the same.

Choice "b" is incorrect. Because consumer demand has increased (not decreased).

Choice "c" is incorrect. An increase in demand has an indeterminate (and irrelevant) impact on the number of buyers. For example, there could be the same number of buyers in the market, but that each demands a higher quality.

QUESTION 483 Which one of the following statements about supply and demand is true?

- A. If supply increases and demand remains constant, equilibrium price will rise.
- B. If demand increases and supply increases, equilibrium quantity will fall.
- C. If demand increases and supply decreases, equilibrium price will increase.
- D. If demand increases and supply remains constant, equilibrium price will fall.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. If quantity demanded for a product goes up, this drives price up. Additionally, if supply decreases, this will also drive prices up. Therefore, it is a certainty that price will be driven up, given an increase in demand and a decrease in supply.

Choice "a" is incorrect. Increased supply will reduce (not increase) prices, assuming demand remains constant.

Choice "b" is incorrect. Increased demand will increase price, and increased supply will reduce price.

The net impact on price cannot be determined without more facts.

Choice "d" is incorrect. Increased demand will increase (not reduce) price, assuming supply remains constant.

QUESTION 484

The local video store's business increased by 12 percent after the movie theater raised its prices from \$6.50 to \$7.00. This is an example of:

- A. Substitute goods.
- B. Superior goods.
- C. Complementary goods.
- D. Independent goods.

Correct Answer: A

Section: Business Environment and Concept

Explanation



Explanation/Reference:

Explanation:

Choice "a" is correct. For substitute goods, as the price of one good goes up, the demand for another, substitute good increases as consumers desire the lower-priced substitute good.

Choice "b" is incorrect. Superior goods. Just as the demand for inferior goods declines with an increase in the income level of a consumer, superior goods will experience a spurt in demand as prices are raised.

Choice "c" is incorrect. The demands for mutually "complementary goods" fluctuate together (e.g., more cereal purchases are accompanied by an increase in the demand for milk). Choice "d" is incorrect.

Independent goods have unrelated demand functions (e.g., bread and vacuum cleaners).

QUESTION 485

An increase in the price of crude oil will have what affect on the equilibrium price and quantity of gasoline?

- A. Price will fall and quantity will rise. B. Price will rise and quantity will fall.
- C. Price will fall and quantity will fall.
- D. Price will rise and quantity will rise.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Crude oil is an input to the production of gasoline. When the price of an input increases, supply shifts left, causing equilibrium price to rise and equilibrium quantity to fall.

Choice "a" is incorrect, since price will rise and quantity will fall.

Choice "c" is incorrect, since price will rise.

Choice "d" is incorrect, since quantity will fall.

QUESTION 486 When the supply of and demand for a good both increase:

- A. Equilibrium price will increase.
- B. Equilibrium price will decrease.
- C. Equilibrium price may increase, decrease, or remain unchanged.
- D. Equilibrium quantity may increase, decrease, or remain unchanged.

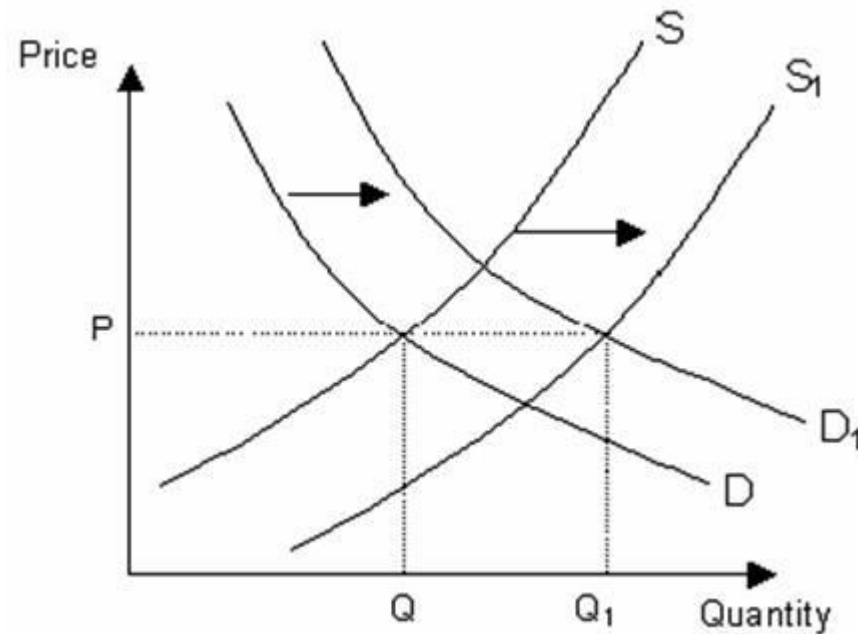
Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:



Choice "c" is correct. When the supply of and demand for a good both increase, equilibrium quantity increases. However, the impact on price is indeterminate. If demand and supply increase by the same amount, price will remain unchanged (as illustrated above). However, if demand increases by more than supply, price will increase. Conversely, if supply increases by more than demand, price will decrease. Choices "a" and "b" are incorrect, since the impact on price is indeterminate. Choice "d" is incorrect, since equilibrium quantity will increase.

QUESTION 487 A basic determinant of the elasticity of demand for a normal good is the:

- A. Length of time producers have to respond to market changes.
- B. Number of substitutes available for the product.
- C. Number of sellers of the product.
- D. Number of complements available for the product.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The change in demand for a product, based upon a given change in that product's price, is dependent on whether or not other (presumably cheaper) goods can be substituted for the product. Choice "a" is incorrect. The elasticity of supply (not demand) would take into account the response time producers might have to market changes. Choice "c" is incorrect. The number of sellers is irrelevant when calculating the elasticity of demand.

Choice "d" is incorrect. A complement good's demand is the same as the primary good. For example, an increase in the demand for a given food would cause the demand for its complement to also increase. The increased demand of the complement is irrelevant when calculating the elasticity of demand.

QUESTION 488

If the elasticity of demand for a normal good is estimated to be 1.5, then a 10% reduction in its price would cause:

- A. Total revenue to fall by 10%.
- B. Total revenue to fall by 15%.
- C. Quantity demanded to rise by 15%.
- D. Demand to decrease by 10%.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The elasticity of demand is calculated as:

% Change in demand

% Change in price

If the elasticity of demand is 1.5 (assumed to be the absolute value, as the elasticity of demand for a normal good is always negative), then a 10% price reduction would cause an increase in the quantity demanded by 15% (a ratio of 15 to 10 or 1.5).

Choices "a", "b", and "d" are incorrect, per Explanation: above.

QUESTION 489

If the demand for a normal good is inelastic, then the sales price of the product would increase following a(n):

- A. Decrease in the price of a substitute good.
- B. Increase in the supply of the product.
- C. Decrease in the supply of the product.
- D. Increase in the number of suppliers of the product.



Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. If demand is perfectly inelastic (or not price sensitive), there will be no change in quantity demanded for a change in price. This means that consumers of the product will demand a constant quantity, regardless of the price. If the quantity supplied is reduced (presumably below an equilibrium point where supply equals demand), there will be excess demand for the product and sales price will go up. The increase in sales price will have no impact on demand (because demand is assumed to be perfectly price inelastic). Choices "a", "b", and "d" are incorrect, per the above Explanation: .

QUESTION 490

The Waymand family typically ate hamburger as a regular staple in their diet. In the last few years, the family income has doubled, and they have now replaced hamburger with steak as a regular staple in their diet. This is an example where the demand for hamburger:

- A. Is relatively elastic.
- B. Is perfectly elastic.
- C. Responds as an inferior good.
- D. Is perfectly inelastic.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. An inferior good is one for which the demand declines as income increases. A normal good would experience an increase in demand in response to an increase in income. Because the demand for hamburger went down as income increased, it is an inferior good.

Choices "a", "b", and "d" are incorrect. The elasticity of demand for a good is calculated by measuring the change in quantity demanded over the change in price (not income). The question does not have sufficient information to calculate the elasticity of the demand for hamburger.

QUESTION 491 A perfectly inelastic supply curve in a competitive market:

- A. Means the equilibrium price must be zero.
- B. Implies a vertical demand curve.
- C. Exists when firms cannot vary input usage.
- D. Says the market supply curve is horizontal.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Price elasticity of supply is calculated the same way as demand except that quantity supplied is measured:

$$\text{Price elasticity of supply \%} = \frac{\% \text{ Change in Q supplied}}{\text{Change in price}}$$

Perfectly inelastic supply curves are also vertical representing that supply is insensitive to changes in price; i.e., the quantity supplied will not change as price changes.

Perfectly inelastic supply curves would exist if firms cannot vary input usage. Regardless of price, the firm has to use all inputs if it produces at all. Choices "a", "b", and "d" are incorrect, as they are far-out distractors.

QUESTION 492 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.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. When a good is demanded, no matter what the price, demand is described as perfectly inelastic. The demand "curve" is a vertical line at the quantity demanded with price making no difference.

Choices "a" and "c" are incorrect. There is no such thing as perfect elasticity. However, the more elastic demand is, the greater the change in quantity demanded for price changes. Choice "d" is incorrect. Diabetics are indifferent to changes in the price of insulin, and to economists, this is perfectly inelastic demand.

QUESTION 493 Demand for a product tends to be

price inelastic if: A. The product is considered a luxury item.

- B. Few good complements for the product are available.
- C. People spend a large share of their income on the product.
- D. Few good substitutes are available for the product.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Demand for a product tends to be price inelastic if few good substitutes are available for the product. Even if price increases, consumers are then unable to switch to substitute goods, because there aren't any. Choice

"a" is incorrect. Luxury items may have good substitutes available.

Choice "b" is incorrect. Complementary goods are those whose demand fluctuates in unison; substitute goods are more relevant here.

Choice "c" is incorrect. If consumers spend a large share of their income on the product, they will be very sensitive to any price changes and hence product demand would be more "elastic."

QUESTION 494

Long Lake Golf Course has raised green fees to a nine-hole game due to an increase in demand.

	Previous Rate	New Rate	Average Games Played at Previous Rate	Average Games Played at New Rate
Regular weekday	\$10	\$11	80	70
Senior citizen	6	8	150	82
Weekend	15	20	221	223

Which of the following is correct?

- A. The regular weekday and weekend demand is inelastic.
- B. The regular weekday and weekend demand is elastic.
- C. The senior citizen and weekend demand is inelastic.
- D. The senior citizen demand is elastic and weekend demand is inelastic.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Demand is elastic if a decline in price (P) results in an increase in total revenue (TR); or if an increase in P results in a decline in TR. On the other hand, if demand is inelastic, a decline in P will result in a decline in TR or an increase in P will result in an increase in TR.

First, the total revenues at both the new and the previous rate must be computed. The (new or previous) rate* average games played (AGP) = the total revenue. As a result, TR at the previous rate (PR) is 800 for regular weekday (RW), 900 for senior citizen (SC), and 3315 for the weekend (WE). TR at the new rate (NR) is 770 for RW, 656 for SC, and 4460 for WE.

So, demand for RW and SC is elastic because the increase in P results in a decline in total revenue. The demand for WE is inelastic because the increase in P results in an increase in TR. As a result, choices "a", "b", and "c" are incorrect.

Note: if TR remains constant after a change in P, the demand is unit elastic.

QUESTION 495

In the long run in a competitive market, a maximum or ceiling price set below the equilibrium price will:

- A. Cause a surplus to be produced.
- B. Have no effect on the market.
- C. Cause a shortage to be created.
- D. Result in a decrease in price.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Setting a ceiling price below the price dictated by market forces (which is the equilibrium price set by the supply and demand curves) would create excess demand for the product (at its reduced price) and, consequently, a shortage.

Choice "a" is incorrect. A surplus would be produced if a floor price (under which no supplier could sell) were set above the equilibrium price, because suppliers would supply excess product at the inflated price. Choices "b" and "d" are incorrect, per the above Explanation: .

QUESTION 496 If the federal government were to regulate a product or service in a competitive market by setting a maximum price that is below the equilibrium price, then in the long run this action will:

- A. Result in a surplus.
- B. Result in a shortage.
- C. Cause a decrease in price.
- D. Have no effect on the market.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Setting a maximum or ceiling price, which is below the equilibrium price dictated by a competitive market, would result in a shortage as a result of excess demand. Choices "a", "c", and "d" are incorrect, per the above Explanation: .

QUESTION 497 A government price support program will:

- A. Lead to surpluses.
- B. Lead to shortages.
- C. Improve the rationing function of prices.
- D. Not influence the rationing function of prices.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A government price support program acts as a subsidy that will encourage suppliers to increase supply beyond an equilibrium point (the point where supply and demand curves intersect). This excess of supply over demand will create surpluses in the market.

Choices "b", "c", and "d" are incorrect, per the above Explanation: .

QUESTION 498 Strategic planning activities normally involve which of the following efforts:

- I. Strategic Positioning.
- II. Value Chain Analysis.
- III. Balance Scorecard Development.

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

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Strategic planning activities are normally acknowledged to include each of three operations including:

- I. Strategic positioning. Strategic positioning includes the process of identifying mission, identifying overall strategy, identifying factors critical to succeeding given the assumed strategy and identifying internal and external factors that contribute or detract from achieving the strategy.
- II. Value chain analysis. Value chain analysis includes the process of identifying the functional characteristics of an organization and the manner in which each one of those functions adds value to the firm's customers.
- III. Balanced scorecard development. Development of a balanced scorecard identifies measurements of value that are both financial and non-financial to be used to monitor and evaluate performance.

Choice "a" is incorrect. All three activities are integral to strategic planning.

Choice "b" is incorrect. All three activities are integral to strategic planning. Choice

"c" is incorrect. All three activities are integral to strategic planning.

QUESTION 499

Economic theory identifies two basic types of goods: inferior goods and superior goods. As consumer income rises, a lower percentage of earnings are expended on inferior goods while a higher percentage of earnings are spent on superior goods. Overall strategies for achieving organizational missions would most likely match with types of goods as follows:

- A. Cost leadership strategies for superior goods, differentiation strategies for inferior goods.
- B. Cost leadership strategies for inferior goods, differentiation strategies for superior goods.
- C. Cost leadership strategies would most likely be used for both inferior and superior goods.
- D. Differentiation strategies would most likely be used for both inferior and superior goods.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Rule: Overall strategies are divided into two different types that are defined as follows:

Cost leadership: Organization seeks to capture market share through maintaining the lowest cost.

Differentiation: Organization seeks to capture market share by demonstrating product value.

Choice "b" is correct. Organizations that sell economically inferior goods (necessities such as cotton swabs, light bulbs, etc.) are more likely to posture themselves as cost leaders than organizations that sell economically superior goods (luxuries such as cruise packages, fine china, jewelry, etc.) who will likely seek to differentiate the value of their product as part of their strategy.

Choice "a" is incorrect. Economically inferior products would likely be associated with cost leadership, not differentiation while economically superior products would likely be associated with differentiation. Choice

"c" is incorrect. Economically inferior products would likely be associated with cost leadership, not differentiation while economically superior products would likely be associated with differentiation.

Choice "d" is incorrect. Economically inferior products would likely be associated with cost leadership, not differentiation while economically superior products would likely be associated with differentiation.

QUESTION 500 Having identified their mission, overall strategy, and critical success factors, organizations often review the internal and external factors that will contribute to their success. This analysis is often referred to as:

- A. TOC evaluation.
- B. Brainstorming.
- C. Balanced scorecard review.
- D. SWOT analysis.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Evaluation of internal and external factors contributing to an organization's success is referred to as Strengths, Weaknesses, Opportunities and Threats (SWOT) analysis. Strengths and weaknesses focus on internal factors while opportunities and threats relate to external factors.

Choice "a" is incorrect. The acronym TOC stands for Theory of Constraints, which is an evaluation technique for optimizing throughput time, it does not relate to overall strategy evaluation.

Choice "b" is incorrect. Brainstorming is a meeting technique used to generate ideas. Although brainstorming could be used as part of an organization's approach to SWOT analysis, it is not, itself, the evaluation of internal and external factors.

Choice "c" is incorrect. A review of the balanced scorecard, which summarizes measures of achievement of critical success factors, does not represent the objective review of internal and external factors that may impact achievement of strategy.

QUESTION 501 Under which of the following conditions is the supplier most able to influence or control buyers?

- A. When the supplier's products are not differentiated.
- B. When the supplier does not face the threat of substitute products.
- C. When the industry is controlled by a large number of companies.
- D. When the purchasing industry is an important customer to the supplying industry.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. When there are few good substitutes for a supplier's product, the supplier has market power (think of a monopoly). As a result, the supplier is better able to control buyers and act as a price setter rather than a price taker.

Choice "a" is incorrect. When supplier's products are not differentiated, buyers will be indifferent about which supplier they purchase from. In other words, if firms sell identical products (think of perfect competition) the product of one firm is a perfect substitute for the product of another firm. In this case, firms are price takers, not price setters.

Choice "c" is incorrect. When there are a large number of firms, no one firm has much market power.

This is the case of either perfect competition (if all firms sell identical products) or monopolistic competition (if all firms sell slightly differentiated products).

Choice "d" is incorrect. If the purchasing industry is an important customer of the supplier, the purchasing industry (i.e. the buyer) will have some market power. This will diminish the ability of the supplier to influence or control the buyer.

QUESTION 502

Which of the following inputs would be most beneficial to consider when management is developing the capital budget?

- A. Supply/demand for the company's products.
- B. Current product sales prices and costs.
- C. Wage trends.
- D. Profit center equipment requests.

Correct Answer: D

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. In developing its capital budget, management would find the employee input associated with equipment requests from various profit centers most helpful. Departmental requests, appropriately justified, would provide key insights into the capital requirements of the business that are not otherwise known.

Choice "a" is incorrect. Supply and demand for company products is a crucial strategic input in forecasting the future capital requirements. Current year capital budgeting would not benefit as directly from this information, however, as profit center equipment requests.

Choice "b" is incorrect. Current product sales prices and costs represent operating data most relevant to operating rather than capital budgeting. Choice

"c" is incorrect. Wage trends represent operating data most relevant to operating than capital budgeting.

QUESTION 503 A city ordinance that freezes rent

prices may cause:

- A. The demand curve for rental space to fall.
- B. The supply curve for rental space to rise.
- C. The quantity demanded of rental space exceeds the quantity supplied.
- D. The quantity supplied of rental space exceeds the quantity demanded.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A city ordinance that freezes rent prices (such as rent control and rent stabilization in New York City) may cause the quantity demanded for rental space to exceed the quantity supplied.

This occurs if the rent-controlled price is set below the market clearing price. At the controlled price, the quantity supplied will be constrained due to the low rent prices for the rent-controlled and rent-stabilized properties; builders will not want to build and rent properties for less than they are worth on the open market. The quantity demanded for the rental space will still be artificially high due to the city ordinance, which sets the controlled price below the market price. Thus, the quantity demanded will exceed the quantity supplied. New York City rent control is a perfect example of the effect of a price ceiling and the problems that it can cause.

Choice "a" is incorrect. A city ordinance that freezes rent prices will not cause the demand curve for rental space to fall. Price changes cause movements along the demand curve, not shifts in the demand curve.
Choice "b" is incorrect. A city ordinance that freezes rent prices will not cause the supply curve for rental space to rise. Price changes cause movements along the supply curve, not shifts in the supply curve. Choice "d" is incorrect. A city ordinance that freezes rent prices will not cause the quantity supplied to exceed the quantity demanded. This choice is backwards.

QUESTION 504 What is strategic planning?

- A. It establishes the general direction of the organization.
- B. It establishes the resources that the plan will require.
- C. It establishes the budget for the organization.
- D. It consists of decisions to use parts of the organization's resources in specified ways.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Strategic planning is the creation of an overall strategic plan for an organization to achieve its overall "business objectives." The strategic plan will establish the general direction of the organization.

Choice "b" is incorrect. Strategic planning will not establish the resources that the plan will require. The resources that the plan will require are part of the implementation of the strategic plan, not part of the plan itself.

Choice "c" is incorrect. Strategic planning will not establish the budget for the organization. Budgets are even further down implementing the plan than are the resources that the plan will require.

Choice "d" is incorrect. Strategic planning does not consist of decisions to use parts of the organization's resources in specified ways. Again, these decisions are part of the implementation of the strategic plan, not part of the plan itself.

QUESTION 505

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

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

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. As inflation associated with a foreign currency increases in relation to a domestic economy, demand for the foreign currency falls. Inflation weakens the foreign currency in relation to the domestic currency and makes foreign products more expensive and reduces demand. Reduced demand for a foreign import will reduce the demand for its currency.

Choice "a" is incorrect. Inflation, along with interest rates and trade restrictions are significant determinants of exchange rates.

Choice "c" is incorrect. As inflation associated with a foreign currency increases in relation to a domestic economy, demand for the foreign currency falls. Inflation weakens the foreign currency in relation to the domestic currency and makes foreign products more expensive and reduces demand. Reduced demand for a foreign import will reduce the demand for its currency, not increase demand.

Choice "d" is incorrect. As inflation associated with a foreign currency decreases in relation to a domestic economy, demand for the foreign currency rises. Inflation weakens the domestic currency in relation to the foreign currency and makes foreign products less expensive and increases demand. Increased demand for a foreign import will increase the demand for its currency, not decrease demand.

QUESTION 506

Which of the following is not correct about the purchasing power parity theory of explaining changes in exchange rates?

- A. Purchasing power of a common currency in different economies for similar products will remain the same.
- B. Inflationary forces on foreign and domestic currencies will cause the exchange rates to automatically adjust to ensure that a common currency will have identical or similar purchasing power in each economy for similar goods.
- C. Interest rates include a premium or discount that ensures purchasing power parity.
- D. The purchasing power parity theory is presented in both absolute and relative form.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The purchasing power parity theory holds that inflation will cause exchange rates to automatically adjust to ensure that an equal amount of a common currency will purchase similar goods in separate economies. The International Fischer effect considers the premium or discount on interest rates as an indicator of inflation.

Choice "a" is incorrect. The basic idea underlying the purchasing power parity theory is that the purchasing power of a common currency in different economies for similar products will remain the same and that inflation in any particular economy will cause exchange rates to adjust until parity is consistently achieved.

Choice "b" is incorrect. The purchasing power parity theory holds that inflationary forces on foreign and domestic currencies will cause the exchange rates to automatically adjust to ensure that a common currency will have identical or similar purchasing power in each economy for similar goods.

Choice "d" is incorrect. The purchasing power parity theory is presented as both an absolute theory of parity determination regardless of market imperfections and as a relative concept that considers market imperfections.

QUESTION 507 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.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The currency variability approach uses standard deviations as a means of predicting future exchange rates while the currency correlation approach is often applied to circumstances involving multiple currencies and evaluates exposure in relation to the statistically computed degree of correlation between the movements of different currencies. Choices "a", "b", and "d" are incorrect, per above Explanation: .

QUESTION 508

Which of the following methods is designed to measure transaction exposure in terms of the maximum one day loss related to holdings denominated in foreign currency?

- I. Measurement of currency variability.
- II.Measurement of currency correlations.III. Value at risk.

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

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The value at risk method seeks to quantify the exposure of business to a one day loss in the value of its positions in foreign currencies. Choices "a", "b", and "d" are incorrect, per above Explanation: .

QUESTION 509

Atlas Worldwide Industries conducts business in a number of different countries and is trying to evaluate its economic exposure to exchange rate risk. Which of the following statements is not correct?

- A. Atlas will suffer an economic loss in the event it has net cash outflows of a foreign currency and the foreign currency appreciates.
- B. Atlas will enjoy an economic gain in the event it has net cash outflows of a foreign currency and the foreign currency depreciates.
- C. Atlas will suffer an economic loss in the event it has net cash inflows of a foreign currency and the foreign currency appreciates.
- D. Atlas will suffer an economic loss in the event it has net cash inflows of a foreign currency and the foreign currency depreciates.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

<u>Domestic Currency</u>	<u>Foreign Currency</u>
<u>Appreciation</u>	<u>Net inflows</u>
<u>Depreciation</u>	<u>Net outflows</u>
	Loss
	Gain
	Loss

Choice "c" is correct. Atlas will benefit from an economic gain in the event that it has net cash inflows of a foreign currency and the foreign currency appreciates (the domestic currency depreciates). Atlas will collect a more valuable currency that can buy more of its domestic currency.

Choices "a", "b", and "d" are incorrect because they are correct statements.

QUESTION 510

Universal Industries limits its operations to exports to foreign countries. What can be said about Universal's exposures to exchange rate risk?

- A. Universal is subject to potential transaction, economic and translation exposures to exchange rate risk.
- B. Universal is subject to potential transaction and economic exposures to exchange rate risk.
- C. Universal is subject to economic and translation exposures to exchange rate risk.
- D. Universal is subject transaction and translation exposures to exchange rate risk.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Universal is subject to transaction risks associated with settlement of export transactions and is subject to economic risks associated with the satisfaction of domestic expenses denominated in domestic currencies with imported revenues denominated in a foreign currency. No translation exposure exists since there is no foreign investment or subsidiary. Choices "a", "c", and "d" are incorrect, per the above Explanation: .

QUESTION 511

Hedgehog International owes 500,000 local currency units to its foreign supplier in 90 days. The current spot rate of the local currency unit is \$.60. Hedgehog purchases a call option to buy the local currency unit in 90 days for \$.61 for a premium of \$.005. The exchange rate for the local currency increases to \$.63 in 90 days. What will Hedgehog do on the payables' settlement date?

- A. Hedgehog will exercise its option and settle the payables with proceeds from the option contract at a gain.
- B. Hedgehog will not exercise the option and settle the payables after purchase of the local currency unit at the spot rate.
- C. Hedgehog will be indifferent as to whether it exercises the option or not.
- D. Hedgehog will sell the option at the settlement date and use its proceeds along with local currency units purchased at the spot rate to satisfy the amount payable.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Hedgehog will exercise its option and liquidate the payables associated with the proceeds. The exercise of the option represents a less costly alternative than acquisition of proceeds at the spot rate at the time the payables are due. The net impact of exercise of the option is computed as follows:

	<u>Required LCU</u>	<u>Exchange @ Settlement</u>	<u>Call Price</u>	<u>Premium</u>	<u>Total</u>	<u>Payables Settlement</u>
Settlement at spot	500,000	\$0.63	\$ -	\$ -	\$ -	\$315,000
Settlement with option	500,000	\$ -	\$0.61	\$0.005	\$0.615	307,500
Net effect: Gain (Loss)						<u>\$ 7,500</u>

The premium is a sunk cost and is irrelevant to the decision. Note that the premium is a factor in determining the net gain (loss) but not in deciding whether to exercise the option. Choices "b", "c", and "d" are incorrect, per computation above.

QUESTION 512

Hedgehog International has a receivable valued at 500,000 local currency units from its foreign customer due in 90 days. The current spot rate of the local currency unit is \$.60. Hedgehog purchases a put option to sell the local currency unit in 90 days for \$.61 for a premium of \$.005. The exchange rate for the local currency increases to \$.63 in 90 days. What will Hedgehog do on the receivable's settlement date?

- A. Hedgehog will exercise its option and sell the proceeds of its accounts receivable collection under the provisions of the option contract at a gain.
- B. Hedgehog will not exercise the option and sell local currency units collected from its receivable at the spot rate.
- C. Hedgehog will be indifferent as to whether it exercises the option or not.
- D. Hedgehog will sell the option at the settlement date and combine its proceeds along with local currency units purchased at the spot rate to maximize its revenue.

Correct Answer: B

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Hedgehog will not exercise its option and will, instead convert the local currency units collected from the receivables to its domestic currency by selling that currency at the spot rate at the time of collection. The exercise of the option represents a less profitable alternative than sale of the accounts receivable proceeds at the spot rate at the time the receivables are collected. The exercise of the option in comparison to allowing the option to expire is computed as follows:

	Required LCU	Exchange @ Settlement	Put Price	Premium	Total	Payables Settlement
Settlement at spot	500,000	\$0.63	\$--	\$--	\$--	\$315,000
Settlement with option	500,000	\$--	\$0.61	\$0.005	\$0.615	307,500
Net effect: Gain (Loss)						<7,500>

The premium is a sunk cost and is irrelevant to the Explanation: . Note that the premium is a factor in determining the net gain (loss) but not in deciding whether to exercise option. Choices "a", "c", and "d" are incorrect, per computation above.

QUESTION 513

Hedgehog International has numerous foreign exchange transactions. Management has elected to hedge transactions as a means of mitigating transaction exposure to exchange rate risk. What is the most effective means that Hedgehog International can use to avoid overhedging?

- A. Hedgehog should acquire parallel loans to provide a means for liquidating unneeded hedge securities.
- B. Hedgehog should acquire the maximum amount required to hedge known and projected transactions.
- C. Hedgehog should acquire the minimum amount required to hedge known transactions.
- D. Hedgehog should enter into a cross hedging agreement.

Correct Answer: C

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Hedgehog should only acquire the minimum amount of hedge contracts needed to offset the effect of known transactions.

Choice "a" is incorrect. Parallel loans represent a swap contract for hedging long-term transaction exposure and are not specifically designed to mitigate the risk of overhedging.

Choice "b" is incorrect. Acquisition of the maximum number of hedge contracts for known and projected transactions exposes the organization to greater risk of overhedging since projected transactions might not materialize. Choice

"d" is incorrect. Cross hedging involves techniques related to currencies that do have hedge instruments available to mitigate risk and are not specifically designed to avoid overhedging.

QUESTION 514 An American importer expects to pay a British supplier 500,000 British pounds in three months. Which of the following hedges is best for the importer to fix the price in dollars?

- A. Buying British pound call options.
- B. Buying British pound put options.
- C. Selling British pound put options.
- D. Selling British pound call options.

Correct Answer: A

Section: Business Environment and Concept

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. To fix a price in dollars to buy British pounds, British pound call options should be purchased. Call options would allow, but not require, the purchaser of the call to acquire the currency (British pounds) for a specified price at or before a specified time in the future. If the price goes down, the purchaser (the importer) would exercise the options; if not, the purchaser (importer) would buy the British pounds in the market and let the options expire. British pound futures could also be used, but that was not one of the choices listed.

Choice "b" is incorrect. Buying British pound put options would allow, but not require, the purchaser of the put to sell the currency for a specified price at a specified time in the future. Since the importer needs British pounds, buying put options would not work. The importer needs to end up with British pounds.

Choice "c" is incorrect. Selling British pound put options would not work. The importer needs to end up with British pounds. Selling put options could work, but the option would be exercised, or not, by the purchaser and not by the importer. If the options were not exercised, the importer could end up with nothing (other than the option premium).

Choice "d" is incorrect. Selling British pound call options would not work. The importer needs to end up with British pounds; if call options are sold, the other party can exercise the options or let them expire, and if the options were exercised, the importer would have to supply the British pounds. This answer is backwards.

QUESTION 515

According to the FASB conceptual framework, the objectives of financial reporting for business enterprises are based on:

- A. Generally accepted accounting principles.
- B. Reporting on management's stewardship.
- C. The need for conservatism.
- D. The needs of the users of the information.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The FASB conceptual framework states that the objectives of financial reporting stem from the informational needs of the external users of the information. SFAC 1 para. 28.

Choice "a" is incorrect. Generally accepted accounting principles (GAAP) are derived from and based on the objectives of financial reporting, not the other way around.

Choice "b" is incorrect. Information concerning management's stewardship is only one aspect of the information financial statements are intended to provide. SFAC 1 para. 50.

Choice "c" is incorrect. Conservatism is an underlying concept for financial accounting but is not the basis for the objectives. SFAC 2 para. 91-97.

QUESTION 516

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.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

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 517

According to the FASB conceptual framework, which of the following attributes would not be used to measure inventory?

- A. Historical cost.

- B. Replacement cost.
- C. Net realizable value.
- D. Present value of future cash flows.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The present value of future cash flows is used to measure long-term receivables or payables, not inventory, because inventory is a short-term asset, which has more immediate cash flows. SFAC 5 para. 67.

Choice "a" is incorrect. Historical cost can be used to measure inventory because it is a relevant and reliable measurement attribute of current assets such as inventory.

Choice "b" is incorrect. Replacement (or current) cost can be used to measure inventory because it is a relevant and reliable measurement attribute of current assets such as inventory. Choice

"c" is incorrect. Net realizable value can be used to measure inventory because it is a relevant and reliable measurement attribute of current assets such as inventory.

QUESTION 518

According to the FASB conceptual framework, which of the following situations violates the concept of reliability?

- A. Data on segments having the same expected risks and growth rates are reported to analysts estimating future profits.
- B. Financial statements are issued nine months late.
- C. Management reports to stockholders regularly refer to new projects undertaken, but the financial statements never report project results.
- D. Financial statements include property with a carrying amount increased to management's estimate of market value.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Management's estimate of market value lacks verifiability, which is a component of reliability. SFAC 2 para. 89 Choice

"a" is incorrect. Communicating data on segments to analysts does not violate the concept of reliability.

Choice "b" is incorrect. Issuing financial statements nine months late violates timeliness, which is a component of relevance, not reliability. SFAC 2 para. 56 Choice

"c" is incorrect. Neglecting to report results of new projects violates full disclosure, not reliability.

QUESTION 519

In the hierarchy of generally accepted accounting principles, APB Opinions have the same authority as AICPA:

- A. Statements of Position.
- B. Industry Audit and Accounting Guides.
- C. Issues Papers.
- D. Accounting Research Bulletins.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. AICPA Accounting Research Bulletins, FASB Standards, FASB Interpretations, FASB Staff Positions, FASB Statement 133 Implementation Issues, and APB Opinions and Interpretations are the most authoritative sources of generally accepted accounting principles.

Choice "a" is incorrect. AICPA Statements of Position, AICPA Accounting and Auditing Guides, and FASB Technical Bulletins are secondary sources of generally accepted accounting principles.

Choice "b" is incorrect. AICPA Statements of Position, AICPA Accounting and Auditing Guides, and FASB Technical Bulletins are secondary sources of generally accepted accounting principles.

Choice "c" is incorrect. AICPA Issues Papers and Practice Bulletins, FASB Concepts Statements, and other authoritative pronouncements are tertiary sources for generally accepted accounting principles.

QUESTION 520 What is the underlying concept that supports the immediate recognition of a contingent loss?

- A. Substance over form.

- B. Consistency.
- C. Matching.
- D. Conservatism.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered. Recognition of a contingent loss is the recording of an amount representing uncertainty and risk in a business situation. SFAC 2, SFAS 5 para. 82

Choice "a" is incorrect. The substance over form concept presumes that the transaction form may not dictate the accounting treatment.

Choice "b" is incorrect. Consistency is conformity from period to period with unchanging policies and procedures. SFAC 2

Choice "c" is incorrect. The matching principle dictates that expenses be matched with the related revenues generated or the time period in which the expense is incurred and known. SFAS #5 cites matching as the one concept supporting the immediate recognition of a contingent loss, but it is not the primary underlying concept. SFAS 5 para. 76

QUESTION 521

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.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

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.

QUESTION 522 What are the Statements of Financial Accounting Concepts intended to establish?

- A. Generally accepted accounting principles in financial reporting by business enterprises.
- B. The meaning of "Present fairly in accordance with generally accepted accounting principles."
- C. The objectives and concepts for use in developing standards of financial accounting and reporting.
- D. The hierarchy of sources of generally accepted accounting principles.

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Statements of Financial Accounting Concepts are intended to establish the objectives and concepts that the Financial Accounting Standards Board will use in developing standards of financial accounting and reporting. SFAC 1 para. 3

Choice "a" is incorrect. The Statements of Financial Accounting Concepts do not specify financial accounting standards prescribing accounting procedures or practices. SFAC 1 para. 3

Choice "b" is incorrect. Auditing standards develop the meaning of "Present fairly in accordance with generally accepted accounting principles." Choice "d" is incorrect. The hierarchy of sources of generally accepted accounting principles is determined by GAAP.

QUESTION 523

During a period when an enterprise is under the direction of a particular management, its financial statements will directly provide information about:

- A. Both enterprise performance and management performance.
- B. Management performance but not directly provide information about enterprise performance.
- C. Enterprise performance but not directly provide information about management performance.
- D. Neither enterprise performance nor management performance.

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Financial reporting, and especially financial statements, usually cannot and do not separate management performance from enterprise performance. Financial reporting provides information about an enterprise during a period when it was under the direction of a particular management but does not directly provide information about that management's performance. SFAC 1 para. 53

QUESTION 524

According to the FASB conceptual framework, which of the following statements conforms to the realization concept?

- A. Equipment depreciation was assigned to a production department and then to product unit costs.
- B. Depreciated equipment was sold in exchange for a note receivable.
- C. Cash was collected on accounts receivable.
- D. Product unit costs were assigned to cost of goods sold when the units were sold.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Revenues and gains are realized when assets are exchanged for cash or claims to cash. SFAC 5 para. 83.

Choice "a" is incorrect. Assigning depreciation in a production department is an example of allocating overhead. There is no realization associated with the assignment.

Choice "c" is incorrect. The realization concept is integral to accounting for revenues and expenses and is not connected to collection of receivables.

Choice "d" is incorrect. Assignment of overhead costs to products and thus to cost of goods sold is an example of matching. There is no realization associated with this assignment.

QUESTION 525

In Yew Co.'s 1992 annual report, Yew described its social awareness expenditures during the year as follows:

"The Company contributed \$250,000 in cash to youth and educational programs. The Company also gave \$140,000 to health and human-service organizations, of which \$80,000 was contributed by employees through payroll deductions. In addition, consistent with the Company's commitment to the environment, the Company spent \$100,000 to redesign product packaging." What amount of the above should be included in Yew's income statement as charitable contributions expense?

- A. \$310,000
- B. \$390,000
- C. \$410,000
- D. \$490,000

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Charitable contributions include amounts the company gave to recognized charities. This includes:

Youth and education programs	\$ 250,000
Health (\$140,000 - \$80,000)	60,000
Total	<u>\$ 310,000</u>

Note: Of the \$140,000, employees gave \$80,000, and the company \$60,000. Redesigning packaging is not a contribution to a charity. Choice "b" is incorrect. The company gave only \$60,000 of the \$140,000. Employees gave \$80,000. Choice "c" is incorrect. Redesigning packaging is not a contribution to a charity. Choice "d" is incorrect. The company gave only \$60,000 of the \$140,000. Employees gave \$80,000. Redesigning packaging is not a contribution to a charity.

QUESTION 526

According to the FASB conceptual framework, which of the following relates to both relevance and reliability?

- A. Comparability.
- B. Feedback value.
- C. Verifiability.
- D. Timeliness.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Comparability and consistency are secondary qualities of both relevance and reliability. SFAC 2 para. 111-122. Choice "b" is incorrect. Feedback value is a key characteristic of relevance only. Choice "c" is incorrect. Verifiability is a key characteristic of reliability only. Choice "d" is incorrect. Timeliness is a key characteristic of relevance only.

QUESTION 527 Which of the following is true regarding the comparison of managerial to financial accounting?

- A. Managerial accounting is generally more precise.
- B. Managerial accounting has a past focus and financial accounting has a future focus.
- C. The emphasis on managerial accounting is relevance and the emphasis on financial accounting is timeliness.
- D. Managerial accounting need not follow generally accepted accounting principles (GAAP) while financial accounting must follow them.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Public companies must follow GAAP for (external) financial reporting purposes. GAAP need not be followed for (internal) managerial accounting purposes. Choice "a" is incorrect. Financial accounting is generally more precise. Choice "b" is incorrect. Managerial accounting has a future focus, while financial accounting focuses on reporting past results. Choice "c" is incorrect. The emphasis of financial accounting is providing useful information to financial statement users (including the characteristic of relevance), while the emphasis of managerial accounting is providing timely information to management decision makers.

QUESTION 528

Which of the following is a generally accepted accounting principle that illustrates the practice of conservatism during a particular reporting period?

- A. Capitalization of research and development costs.
- B. Accrual of a contingency deemed to be reasonably possible.
- C. Reporting investments with appreciated market values at market value.
- D. Reporting inventory at the lower of cost or market value.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The rule of conservatism states that revenues and gains should be recognized when the earnings process is complete, but that expenses and losses should be expensed immediately. Reporting inventory at the lower of cost or market requires the recording of a loss on inventory when market is lower than cost in the period the loss is sustained, rather than when the inventory is sold, consistent with the rule of conservatism. Choice "a" is incorrect. Because the future benefits of R&D costs are questionable, these cost should be expensed immediately, consistent with the rule of conservatism and the matching principle. Choice "b" is incorrect. The rule of conservatism only requires the accrual of "probable" losses. The accrual of a reasonably possible loss is not required and the accrual of any contingent gain, whether probable, reasonably possible, or remote, is prohibited. Choice "c" is incorrect. The reporting of marketable securities with appreciated values at market value requires the recording of a gain on the asset before the gain is realized. This contradicts the rule of conservatism, but is allowed because fair value is a more relevant measure of the value of marketable securities.

QUESTION 529

Arpco, Inc., a for-profit provider of healthcare services, recently purchased two smaller companies and is researching accounting issues arising from the two business combinations. Which of the following accounting pronouncements are the most authoritative?

- A. AICA Statements of Position.
- B. AICPA Industry and Audit Guides.
- C. FASB Statements of Financial Accounting Concepts.
- D. FASB Statements of Financial Accounting Standards.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Since Arpco is a for-profit provider of healthcare services, it is covered under normal GAAP. Thus, the most authoritative pronouncements are the FASB Statements of Financial Accounting Standards (SFAS). Choice "a" is incorrect. AICPA Statements of Position are not the most authoritative pronouncement for almost anything (other than for some issues that only they cover). They are normally "merely" the opinion of the AICPA.

Choice "b" is incorrect. AICPA Industry and Audit Guides are not the most authoritative pronouncement for almost anything (other than for some issues that only they cover).

Choice "c" is incorrect. FASB Statements of Financial Accounting Concepts are not authoritative pronouncements except where they have been incorporated by reference into an SFAS. They are the basis on which SFAS can be constructed.

QUESTION 530 According to the FASB conceptual framework, the quality of information that helps users increase the likelihood of correctly forecasting the outcome of past or present events is called:

- A. Feedback value.
- B. Predictive value.
- C. Representational faithfulness.
- D. Reliability.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The quality of information that helps users increase the likelihood of correctly forecasting the outcome of past or present events is called predictive value. Forecasting is predicting.

Choice "a" is incorrect. The quality of information that helps users increase the likelihood of correctly forecasting the outcome of past or present events is called predictive value, not feedback value. Feedback value enables decision makers to confirm prior expectations or to adjust or correct the decisions made previously.

Choice "c" is incorrect. The quality of information that helps users increase the likelihood of correctly forecasting the outcome of past or present events is called predictive value, not representational faithfulness. Representational faithfulness is the agreement between financial reporting and the resources or events represented.

Choice "d" is incorrect. The quality of information that helps users increase the likelihood of correctly forecasting the outcome of past or present events is called predictive value, not reliability. Reliability is the combination of neutrality, representational faithfulness, and verifiability.

QUESTION 531 Which of the following assumptions means that money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis?

- A. Going concern.
- B. Periodicity.
- C. Monetary unit.
- D. Economic entity.

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The monetary unit assumption means that money is the common denominator for economic activity and provides an appropriate basis for accounting measurements and analysis.

Choice "a" is incorrect. The going concern assumption has nothing to do with money per se. The going concern assumption presumes that an entity will continue to operate in the foreseeable future.

Choice "b" is incorrect. The periodicity has nothing to do with money per se. The periodicity assumption is that economic activity can be divided into meaningful time periods.

Choice "d" is incorrect. The economic entity assumption has nothing to do with money per se. The economic entity assumption is that economic activity can be accounted for when considering an identifiable set of activities.

QUESTION 532

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.

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. A new statement from the FASB is issued only after a majority vote of the members of the FASB.

Choice "a" is incorrect. There is no necessity for the EITF to approve a discussion memorandum (presumably the question means a discussion memorandum of the FASB statement itself and not an EITF statement) before it is disseminated to the public.

Choice "b" is incorrect. There is no necessity for an exposure draft to be modified per public opinion before issuing the discussion memorandum (a question can be raised here as to "what" discussion memorandum"). Exposure drafts are quite/most often modified before they are issued as FASB statements, but they do not have to be. Whether they are or are not modified is a function of whether the FASB thinks they should be modified, partly due to the public comments that have been received.

Choice "d" is incorrect. There is no way to rescind a new FASB statement, although, in reality, a FASB statement can be rescinded by the issuance of a new statement on the same subject. However, even if there was a way to rescind a new FASB statement, it would not be by a majority vote of the AICPA membership, but by a majority vote of the members of the FASB.

QUESTION 533

Income tax-basis financial statements differ from those prepared under GAAP in that income tax-basis financial statements:

- A. Do not include nontaxable revenues and nondeductible expenses in determining income.
- B. Include detailed information about current and deferred income tax liabilities.
- C. Contain no disclosures about capital and operating lease transactions.
- D. Recognize certain revenues and expenses in different reporting periods.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Income tax-basis financial statements recognize events when taxable income or deductible expenses are recognized on the entity's tax return. Non-taxable income and non-deductible expenses are shown on the financial statement and included in the determination of income (and become M-1 adjustments to arrive at taxable income).

Please Note: This question appeared in the releases for 1999 in FARE; however, it may also apply to OCBOA financial statements discussed in the Auditing textbook. The question did not apply well to any FARE CSO line item, so we included it here so that you could read the Explanation: and learn from it.

QUESTION 534 An extraordinary gain should be reported as a direct increase to which of the following?

- A. Net income.

- B. Comprehensive income.
- C. Income from continuing operations, net of tax.
- D. Income from discontinued operations, net of tax.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Extraordinary items are reported as a component of net income, after income from continuing operations and discontinued operations.

Choice "b" is incorrect. An extraordinary gain (or loss) only indirectly affects comprehensive income as a component of net income.

Choice "c" is incorrect. Extraordinary items are reported net of tax after income from continuing operations and discontinued operations.

Choice "d" is incorrect. Extraordinary items are reported net of tax after income from continuing operations and discontinued operations.

QUESTION 535

On December 2, 20X1, Flint Corp.'s board of directors voted to discontinue operations of its frozen food division and to sell the division's assets on the open market as soon as possible. The division reported net operating losses of \$20,000 in December and \$30,000 in January. On February 26, 20X2, sale of the division's assets resulted in a gain of \$90,000. Assuming that the frozen foods division qualifies as a component of the business and ignoring income taxes, what amount of gain/loss from discontinued operations should Flint recognize in its income statement for 20X2?

- A. \$0
- B. \$40,000C. \$60,000
- D. \$90,000

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The \$60,000 gain from discontinued operations would be reported in Flint's 20X2 income statement. The operating loss for January would offset the gain from disposal in February, and the net amount would be reported as a gain (in this case) from discontinued operations.

The operating losses for December would have been reported in Flint's 20X1 income statement.

Choice "a" is incorrect per the above. It would be correct if all of the gains and losses were included in 20X1 instead of 20X2. However, gains and losses from discontinued operations are included in the year they occur.

Choice "b" is incorrect. It includes the operating loss for December, 20X1 in with the 20X2 amounts.

Choice "d" is incorrect. It ignores the January operating loss. Operating losses are included in gain/loss from discontinued operations, along with impairment losses and gains/losses on disposal.

QUESTION 536

At December 31, 1998, Off-Line Co. changed its method of accounting for demo costs from writing off the costs over two years to expensing the costs immediately. Off-Line made the change in recognition of an increasing number of demos placed with customers that did not result in sales. Off-Line had deferred demo costs of \$500,000 at December 31, 1997, \$300,000 of which were to be written off in 1998 and the remainder in 1999. Off-Line's income tax rate is 30%. In its 1998 financial statements, what amount should Off-Line report as cumulative effect of change in accounting principle?

- A. \$0
- B. \$200,000
- C. \$350,000D. \$500,000 **Correct Answer:** A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. When a change in accounting principle is considered inseparable from a change in estimate, the change is handled as a change in estimate - prospectively. No cumulative effect adjustment is made. Choices

"b", "c", and "d" are incorrect since no cumulative effect adjustment is made.

QUESTION 537

How should the effect of a change in accounting principle that is inseparable from the effect of a change in accounting estimate be reported?

- A. As a component of income from continuing operations.
- B. By restating the financial statements of all prior periods presented.

- C. As a correction of an error.
- D. By footnote disclosure only.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. When the effect of a change in accounting principle is inseparable from the effect of a change in accounting estimate, the reporting treatment for the overall effect is as a change in estimate.

Thus, the effect is reported prospectively as a component of income from continuing operations. Under SFAS No. 154, this type of change is now called a change in accounting estimate affected by a change in accounting principle. Choice "b" is incorrect. Restatement of all prior periods is the retroactive accounting treatment that is applied to the correction of an error and the retrospective accounting treatment given to changes in accounting principle. However, a change in accounting principle that is inseparable from the effect of a change in accounting estimate is now treated as a change in accounting estimate.

Choice "c" is incorrect. Correction of an error is given retroactive treatment as a prior period adjustment to retained earnings with restatement of prior periods. This is not the treatment appropriate for the effect of a change in accounting principle that is inseparable from the effect of a change in accounting estimate.

Choice "d" is incorrect. While footnote disclosure is always appropriate for an accounting change, such disclosure alone is never the appropriate accounting treatment.

QUESTION 538

In September 1996, Koff Co.'s operating plant was destroyed by an earthquake. Earthquakes are rare in the area in which the plant was located. The portion of the resultant loss not covered by insurance was \$700,000. Koff's income tax rate for 1996 was 40%. In its 1996 income statement, what amount should Koff report as extraordinary loss?

- A. \$0
- B. \$280,000
- C. \$420,000
- D. \$700,000

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. For a loss to be reported as an extraordinary loss, the event causing the loss must be both unusual in nature and infrequent in occurrence. The earthquake in this case does meet these criteria so the loss is reported net of income tax effect as an extraordinary loss of \$420,000 (60% of the total \$700,000 loss). APB 30.11, .19-.26 Choice "a" is incorrect. Review the criteria for reporting an extraordinary loss.

Choice "b" is incorrect. This is the tax effect of the loss. Review your calculations.

Choice "d" is incorrect. It is not appropriate to report the full loss as an extraordinary loss.

QUESTION 539

In April 30, 20X4, Deer Corp. approved a plan to dispose of a component of its business. For the period January 1 through April 30, 20X4, the component had revenues of \$500,000 and expenses of \$800,000.

The assets of the component were sold on October 15, 20X4 at a loss. In its income statement for the year ended December 31, 20X4, how should Deer report the component's operations from January 1 to April 30, 20X4?

- A. \$500,000 and \$800,000 should be included with revenues and expenses, respectively, as part of continuing operations.
- B. \$300,000 should be reported as part of the loss on disposal of a component and included as part of continuing operations.
- C. \$300,000 should be reported as an extraordinary loss.
- D. \$300,000 should be reported as a loss from operations of a component and included in loss from discontinued operations.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Once the decision has been made to dispose of a component of a business and that component meets the criteria to be classified as held for sale, the operating results of the component for the period reported on, and any gain or loss from the disposal, should be reported separately from continuing operations, net of tax. In this question, the component was classified as held for sale and was sold in the same year.

Thus, in 20X4, the results of operations, the \$300,000 (\$500,000-\$800,000) loss, are reported as a loss from discontinued operations. The loss on disposal would be reported as part of that loss from discontinued operations also.

Choice "a" is incorrect. The results of operations prior to the decision date, and also after the decision date, are reported separately from the results of continuing operations as a part of discontinued operations.

Choice "b" is incorrect. The results of operations prior to the decision date, and also after the decision date, are reported separately from the results of continuing operations as a loss from operations of a component and included in loss from discontinued operations.

Choice "c" is incorrect. The results of discontinued operations are not reported as an extraordinary item.

QUESTION 540

In open market transactions, Gold Corp. simultaneously sold its long-term investment in Iron Corp. bonds and purchased its own outstanding bonds. The broker remitted the net cash from the two transactions. Gold's gain on the purchase of its own bonds exceeded its loss on the sale of the Iron bonds. Assume the transaction to purchase its own outstanding bonds is unusual in nature and has occurred infrequently. Gold should report the:

- A. Net effect of the two transactions as an extraordinary gain.
- B. Net effect of the two transactions in income before extraordinary items.
- C. Effect of its own bond transaction gain in income before extraordinary items, and report the Iron bond transaction as an extraordinary loss.
- D. Effect of its own bond transaction as an extraordinary gain, and report the Iron bond transaction loss in income before extraordinary items.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct, these are two separate transactions because Gold Corp. (1) sold Iron Corp. bonds (an investment) for a loss, and, (2) bought back its own (Gold) Corp. bonds (a debt) for a gain. This is not a "refinancing" (where one would sell new bond debt to buy back old bond debt outstanding).

The gain from the purchase of its own bonds is an "extraordinary gain" because it is both unusual in nature and infrequently occurring (per APB Opinion No. 30 and SFAS No. 145). The Iron Corp. transaction is a loss in "income before extraordinary items."

Choices "a" and "b" are incorrect. The two transactions are separate and cannot be netted.

Choice "c" is incorrect. Just the opposite. The sale of the investment is a loss in "income before extraordinary items," while the purchase of its bond debt is an "extraordinary gain" according to the provisions of APB Opinion No. 30.

QUESTION 541

Lore 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 Lore'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.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

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 542

A material loss should be presented separately as a component of income from continuing operations when it is:

- A. An extraordinary item.
- B. A cumulative effect type change in accounting principle.
- C. Unusual in nature and infrequent in occurrence.
- D. Not unusual in nature but infrequent in occurrence.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Gains or losses that are unusual in nature or occur infrequently but not both, are presented as a component of income from continuing operations.

Choice "a" is incorrect. Extraordinary items are shown net of tax in a separate section of the income statement after income from continuing operations.

Choice "b" is incorrect. Cumulative effects of changes in accounting principle are now shown net of tax as an adjustment to the opening balance of retained earnings in the retained earnings statement. This treatment is called retrospective application. There really are no longer any cumulative effect types of changes in accounting principle. The cumulative effect is merely how the amount of the change is measured. Choice "c" is incorrect. This is the definition of an extraordinary item.

QUESTION 543

During 1994, Orca Corp. decided to change from the FIFO method of inventory valuation to the weighted-average method. Inventory balances under each method were as follows:

	<u>FIFO</u>	<u>Weighted-average</u>
January 1, 1994	\$71,000	\$77,000
December 31, 1994	79,000	83,000

Orca's income tax rate is 30%.

Orca should report the cumulative effect of this accounting change as a(n):

- A. Adjustment to beginning retained earnings.
- B. Component of income from continuing operations.
- C. Extraordinary item.
- D. Component of income after extraordinary items.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation



Explanation/Reference:

Explanation:

Choice "a" is correct. The cumulative effect of a change in accounting principle is shown as an adjustment to beginning retained earnings.

Choice "b" is incorrect. The cumulative effect of a change in accounting principle is now presented as a separate category on the retained earnings statement and is not a component of net income.

Choice "c" is incorrect. Extraordinary items are unusual and infrequent in nature. Extraordinary items have nothing to do with changes in accounting principle. Choice "d" is incorrect. A change in accounting principle affects retained earnings, not the income statement, under SFAS No. 154.

QUESTION 544

A transaction that is unusual in nature and infrequent in occurrence should be reported separately as a component of income:

- A. After cumulative effect of accounting changes and before discontinued operations of a segment of a business.
- B. After cumulative effect of accounting changes and after discontinued operations of a segment of a business.
- C. Before cumulative effect of accounting changes and before discontinued operations of a segment of a business.
- D. After discontinued operations of a segment of a business.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. An extraordinary item (a transaction that is both "unusual in nature" and "infrequent in occurrence") should be reported separately as a component of income after discontinued operations of a segment of a business.

The cumulative effect of a change in accounting principle is shown on the retained earnings statement. This is why memorizing the mnemonic "idea" is so important.

QUESTION 545 How should the effect of a change in accounting estimate be accounted for?

- A. By restating amounts reported in financial statements of prior periods.
- B. By reporting pro forma amounts for prior periods.

- C. As a prior period adjustment to beginning retained earnings.
D. In the period of change and future periods if the change affects both.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct, a "change in accounting estimate" affects only the current and subsequent (future) periods, if the change affects both. It does not affect "prior periods," nor "retained earnings."

Choice "a" is incorrect. Restating prior years' financial statements is required when comparative financial statements are shown for prior period adjustments of "corrections of errors," "changes in entities," and changes in accounting principle.

Choices "b" and "c" are incorrect. A "change in accounting estimate" does not affect prior periods.

QUESTION 546

Foy 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 Foy report as prior period adjustments in 1993?

- A. \$0
B. \$30,000C. \$50,000
D. \$80,000

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. \$50,000.

The cumulative effect of a change in accounting principle is now shown on the retained earnings statement as an adjustment to the beginning balance of retained earnings, assuming that the cumulative effect can be calculated.

An exception is made however, for a change in depreciation method, since a change in depreciation method is no longer considered to be a change in accounting principle. A change in depreciation method is now considered to be both a change in method and a change in estimate. These changes should now be accounted for as a change in estimate and handled prospectively. The new depreciation method should be used as of the beginning of the year of change and should start with the current book value of the underlying asset. No retroactive or retrospective calculations should be made, and no adjustment should be made to retained earnings.

The correction of the failure to accrue warranty costs is treated as a correction of an error and thus as a prior period adjustment. Choices

"a", "b", and "d" are incorrect, per the above explanation.

QUESTION 547

The following question is based on the following:

Vane Co.'s trial balance of income statement accounts for the year ended December 31, 2002, included the following:

	<u>Debit</u>	<u>Credit</u>
Sales		\$575,000
Cost of sales	\$240,000	
Administrative expenses	70,000	
Loss on sale of equipment	10,000	
Sales commissions	50,000	
Interest revenue		25,000
Freight out	15,000	
Loss on early retirement of long-term debt (unusual & infrequent item)	20,000	
Uncollectible accounts expense	15,000	
Totals	<u>\$420,000</u>	<u>\$600,000</u>

Other information

Finished goods inventory:

January 1, 2002	\$400,000
December 31, 2002	\$360,000

Vane's income tax rate is 30%.

In Vane's 2002 multiple-step income statement, what amount should Vane report as income from continuing operations?

- A. \$126,000
- B. \$129,500
- C. \$140,000
- D. \$147,000

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

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

Net of credits over debits (\$600-420)	\$180,000
add: extraordinary item - loss on early retirement of long-term debt	<u>20,000</u>
Income from continuing operations	200,000
"Net of tax" rate (100%-30% tax)	<u>70%</u>
Income after income taxes from continuing operations	<u>\$140,000</u>

QUESTION 548

The effect of a material transaction that is infrequent in occurrence but not unusual in nature should be presented separately as a component of income from continuing operations when the transaction results in a:

	<u>Gain</u>	<u>Loss</u>
A. Yes	Yes	Yes
B. Yes	No	No
C. No	No	No
D. No	No	Yes



A. Option A B.

Option B

C. Option C D.

Option D

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct, Yes - Yes. A material transaction that is "infrequent in occurrence" but not "unusual in nature" should be presented separately as a component of "income from continuing operations" when the transaction results in a gain or loss.

QUESTION 549

An extraordinary item should be reported separately on the income statement as a component of income:

	<u>Net of income taxes</u>	<u>Before discontinued operations of a segment of a business</u>
A.	Yes	Yes
B.	Yes	No
C.	No	No
D.	No	Yes

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct, Yes - No. An extraordinary item should be reported separately on the income statement as a component of income: Yes
- net of income taxes.

No - after (not before) "discontinued operations of a segment of a business."

QUESTION 550

On January 2, 20X5, to better reflect the variable use of its only machine, Holly, Inc. elected to change its method of depreciation from the straight-line method to the units of production method. The original cost of the machine on January 2, 20X3, was \$50,000, and its estimated life was 10 years. Holly estimates that the machine's total life is 50,000 machine hours. Machine hours usage was 8,500 during 20X4 and 3,500 during 20X3. Holly's income tax rate is 30%. Holly should report the accounting change in its 20X5 financial statements as a(n):

- A. Cumulative effect of a change in accounting principle of \$2,000 in its income statement.
- B. Adjustment to beginning retained earnings of \$2,000.
- C. Cumulative effect of a change in accounting principle of \$1,400 in its income statement.
- D. None of the above.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A change in the method of depreciation is now considered to be both a change in method and a change in estimate. These changes should be accounted for as changes in estimate and handled prospectively. The new depreciation method should be used as of the beginning of the year of change and should start with the current book value of the underlying asset. No retroactive or retrospective calculations should be made, and no adjustment should be made to retained earnings.

The cumulative effect treatment on the income statement was the treatment of most changes in accounting principle prior to SFAS No. 154. The adjustment to beginning retained earnings is the treatment now given to changes in accounting principle by SFAS No. 154. However, a change in depreciation method is no longer accounted for as a change in accounting principle. Choices "a", "b", and "c" are incorrect, per the above explanation.

QUESTION 551

On November 1, 20X2, Smith 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 Smith'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.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The operating losses to be included in Smith's 20X2 income statement would be the total 20X2 operating losses, regardless of whether those losses occurred before or after the date the decision to dispose of the component was made, and not any 20X3 operating losses. Projected operating losses are not anticipated and accrued.

Choice "a" is incorrect. The operating losses to be included in Smith's 20X2 income statement would be the total 20X2 operating losses, regardless of whether those losses occurred before or after the date the decision to dispose of the component was made, and not any 20X3 operating losses.

Choice "b" is incorrect. The operating losses to be included in Smith's 20X2 income statement would be the total 20X2 operating losses, regardless of whether those losses occurred before or after the date the decision to dispose of the component was made, and not any 20X3 operating losses.

Choice "c" is incorrect. The operating losses to be included in Smith's 20X2 income statement would be the total 20X2 operating losses, regardless of whether those losses occurred before or after the date the decision to dispose of the component was made, and not any 20X3 operating losses.

QUESTION 552

If a company is not presenting comparative financial statements, the correction of an error in the financial statements of a prior period should be reported, net of applicable income taxes, in the current:

- A. Retained earnings statement after net income but before dividends.
- B. Retained earnings statement as an adjustment of the opening balance.
- C. Income statement after income from continuing operations and before extraordinary items.
- D. Income statement after income from continuing operations and after extraordinary items.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The correction of an error in the financial statements of a prior period should be reported, net of tax, in the current statement of retained earnings as an adjustment of the opening balance. Choice "a" is incorrect. The adjustment is before net income, not after net income.

Choices "c" and "d" are incorrect. Corrections of errors of prior periods go to retained earnings and do not affect the income statement.

QUESTION 553 The cumulative effect of a change in accounting estimate should be shown separately:

- A. On the income statement above income from continuing operations.
- B. On the income statement after income from continuing operations and before extraordinary items.
- C. On the retained earnings statement as an adjustment to the beginning balance.
- D. It should not be recorded separately on any financial statement.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A change in estimate is handled prospectively. No cumulative effect adjustment is made and no separate line item presentation is made on any financial statement. If a material change is being made, appropriate footnote disclosure is necessary.

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

QUESTION 554

The following costs were incurred by Griff Co., a manufacturer, during 1992:



Accounting and legal fees	\$ 25,000
Freight-in	175,000
Freight-out	160,000
Officers salaries	150,000
Insurance	85,000
Sales representatives salaries	215,000

What amount of these costs should be reported as general and administrative expenses for 1992?

- A. \$260,000
- B. \$550,000
- C. \$635,000
- D. \$810,000

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. General and administrative expenses include:

Accounting and legal	\$ 25,000
Officers salaries	150,000
Insurance	85,000
Total	<u>\$260,000</u>



Freight-in is part of cost of sales; freight-out is a selling expense; and sales salaries are selling expenses.

Choice "b" is incorrect. Freight-in is part of cost of inventory; freight-out is a selling expense; and sales salaries are selling expenses. Choice

"c" is incorrect. Freight-in is part of cost of inventory; freight-out is a selling expense; and sales salaries are selling expenses.

Choice "d" is incorrect. Freight-in is part of cost of inventory; freight-out is a selling expense; and sales salaries are selling expenses.

QUESTION 555

On January 2, 1989, Union Co. purchased a machine for \$264,000 and depreciated it by the straight-line method using an estimated useful life of eight years with no salvage value. On January 2, 1992, Union determined that the machine had a useful life of six years from the date of acquisition and will have a salvage value of \$24,000. An accounting change was made in 1992 to reflect the additional data. The accumulated depreciation for this machine should have a balance at December 31, 1992, of:

- A. \$176,000
- B. \$160,000C. \$154,000
- D. \$146,000

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct, \$146,000 accumulated depreciation balance at Dec. 31, 1992.

	depreciable cost	useful life	annual deprec	years elapsed	accumulated deprec
Original	\$264 ÷	8 yrs	= \$33	x 3yrs	= \$99 ('89-'91)
Accum deprec	(99)				
NBV	<u>165</u>				
12/31/91	<u><24></u>				
Salvage	141 ÷	3 yrs	= 47	x 1 yr	= 47 (1992)
Revised Balance, 12/31/92					\$146

QUESTION 556

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

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



- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct, No - No. This is a change in "accounting estimate," which affects only the current and subsequent periods (not prior periods and not retained earnings). "Cumulative effect of a change in accounting principle" is only used for changes in "accounting principle."

QUESTION 557 On August 31, 1992, Harvey Co. decided to change from the FIFO periodic inventory system to the weighted average periodic inventory system. Harvey is on a calendar year basis. The cumulative effect of the change is determined:

- A. As of January 1, 1992.
- B. As of August 31, 1992.
- C. During the eight months ending August 31, 1992, by a weighted average of the purchases.

D. During 1992 by a weighted average of the purchases.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct, as of January 1, 1992, the beginning of the year.

Rule: The cumulative effect of a change in accounting principle equals the difference between retained earnings at the beginning of period of the change and what retained earnings would have been if the change was applied to all affected prior periods, assuming comparative financial statements are not presented. If comparative statements are presented, then beginning retained earnings of the earliest year presented is adjusted for the cumulative effect of the change. We are assuming, based on the answer options given, that Harvey is not presenting comparative financial statements.

Choice "b" is incorrect. The cumulative effect of the change is not determined as of the date the decision is made. Choices

"c" and "d" are incorrect. The cumulative effect of the change is not determined by a weighted average.

QUESTION 558

In 1992, hail damaged several of Toncan Co.'s vans. Hailstorms had frequently inflicted similar damage to Toncan's vans. Over the years, Toncan had saved money by not buying hail insurance and either paying for repairs, or selling damaged vans and then replacing them. In 1992, the damaged vans were sold for less than their carrying amount. How should the hail damage cost be reported in Toncan's 1992 financial statements?

- A. The actual 1992 hail damage loss as an extraordinary loss, net of income taxes.
- B. The actual 1992 hail damage loss in continuing operations, with no separate disclosure.
- C. The expected average hail damage loss in continuing operations, with no separate disclosure.
- D. The expected average hail damage loss in continuing operations, with separate disclosure.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Actual hail damage must be reported. Since the hailstorms are frequent, the damage is not considered an extraordinary gain/loss. Thus, the damages would be shown in continuing operations. No separate disclosure is necessary since hail damage is a common occurrence.

Choice "a" is incorrect. Hailstorms are not unusual and infrequent so the loss could not be classified as extraordinary. APB 30 para. 20

Choice "c" is incorrect. Actual hail damage must be reported. Estimated hail damage may be probable but is not estimable; so it should not be included in income calculations. Choice

"d" is incorrect. Estimated hail damage may be probable but is not estimable; so it should not be included in income calculations.

QUESTION 559

A segment of Ace Inc. was discontinued during 1992. Ace's loss from discontinued operations should not:

- A. Include employee relocation costs associated with the decision to dispose.
- B. Exclude operating losses from the date the decision to dispose of the segment was made until the end of 1992.
- C. Include additional pension costs associated with the decision to dispose.
- D. Include operating losses of the current period up to the date the decision to dispose of the segment was made.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Ace's loss on discontinued operations should not exclude operating losses from the date the decision to dispose of the segment was made until the end of 1992. All 1992 operating losses should be included. Choice

"a" is incorrect. Employee relocation costs associated with the decision to dispose should be included in the loss from discontinued operations.

Choice "c" is incorrect. Additional pension costs associated with the decision to dispose should be included in the loss from discontinued operations.

Choice "d" is incorrect. Ace's loss on discontinued operations should include operating losses of the current period up to the date the decision to dispose of the segment was made and also after that date.

QUESTION 560

On December 31, 20X2, the Board of Directors of Maxy Manufacturing, Inc. committed to a plan to discontinue the operations of its Alpha division. Maxy estimated that Alpha's 20X3 operating loss would be \$500,000 and that the fair value of Alpha's facilities was \$300,000 less than their carrying amounts.

Alpha's 20X2 operating loss was \$1,400,000, and the division was actually sold for \$400,000 less than its carrying amount in 20X3. Maxy's effective tax rate is 30%. In its 20X2 income statement, what amount should Maxy report as loss from discontinued operations?

- A. \$980,000
- B. \$1,190,000
- C. \$1,400,000
- D. \$1,700,000

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Since the fair value of Alpha's facilities was \$300,000 less than its carrying value, there has been an impairment loss, and that loss should be recognized in 20X2. That \$300,000 impairment loss plus the \$1,400,000 20X2 operating loss would be recognized in 20X2 net of tax. The total loss would be $\$1,700,000 \times 70\%$ (100% - 30%) or \$1,190,000.

Choice "a" is incorrect. It includes the 20X2 operating loss of \$1,400,000 but not the \$300,000 impairment loss but does report the 20X2 operating loss net of tax.

Choice "c" is incorrect. It includes the 20X2 operating loss of \$1,400,000, but not the \$300,000 impairment loss, and reports the 20X2 operating loss gross of tax and not net of tax. Choice

"d" is incorrect. It reports the 20X2 loss from discontinued operations gross of tax and not net of tax.

QUESTION 561

On December 31, 20X2, the Board of Directors of Maxy Manufacturing, Inc. committed to a plan to discontinue the operations of its Alpha division. Maxy estimated that Alpha's 20X3 operating loss would be \$500,000 and that the fair value of Alpha's facilities was \$300,000 less than their carrying amounts.

The estimate for 20X3 turned out to be correct. Alpha's 20X2 operating loss was \$1,400,000, and the division was actually sold for \$400,000 less than its carrying amount. Maxy's effective tax rate is 30%. In its 20X3 income statement, what amount should Maxy report as loss from discontinued operations?

- A. \$350,000
- B. \$500,000
- C. \$420,000
- D. \$600,000



Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The 20X3 loss from discontinued operations would include both the 20X3 operating loss of \$500,000 (which turned out to be a correct estimate) and the "additional" loss (on disposal) of \$100,000, net of tax, for a total of $\$600,000 \times .70$ or \$420,000.

Choice "a" is incorrect. It includes the 20X3 operating loss of \$500,000 but not the \$300,000 impairment loss but does report the 20X3 operating loss net of tax.

Choice "b" is incorrect. It includes the 20X3 operating loss of \$500,000, but not the \$100,000 loss on disposal, and reports the 20X3 operating loss gross of tax and not net of tax.

Choice "d" is incorrect. It reports the 20X3 loss from discontinued operations gross of tax and not net of tax. The 20X3 loss from discontinued operations should include both the 20X3 operating loss of \$500,000 and the loss on disposal of \$100,000, net of tax, for a total of $\$600,000 \times .70$ or \$420,000.

QUESTION 562 In which of the following situations should a company report a prior-period adjustment?

- A. A change in the estimated useful lives of fixed assets purchased in prior years.
- B. The correction of a mathematical error in the calculation of prior years' depreciation.
- C. A switch from the straight-line to double-declining balance method of depreciation.
- D. The scrapping of an asset prior to the end of its expected useful life.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Prior period adjustments consist of: corrections of errors in the financial statements of prior periods, retroactive restatements required by new GAAP pronouncements, and changes from a non-GAAP method of accounting to a GAAP method of accounting (which are corrections of errors).

Choice "a" is incorrect. This change is a change in accounting estimate.

Choice "c" is incorrect. This change is a change for one GAAP method of depreciation to another GAAP method of depreciation. Under SFAS No. 154, it is treated as a change in accounting estimate effected by a change in accounting principle and is handled prospectively, and not as a prior-period adjustment. Choice "d" is incorrect. This is a business activity ordinary in nature.

QUESTION 563

Mellow Co. depreciated a \$12,000 asset over five years, using the straight-line method with no salvage value. At the beginning of the fifth year, it was determined that the asset will last another four years. What amount should Mellow report as depreciation expense for year 5?

- A. \$600
- B. \$900
- C. \$1,500
- D. \$2,400

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Over the first 4 years, the asset would be depreciated down to \$2,400. Once it was determined that the asset would last for another 4 years, \$600 would be depreciated each year of that 4 year period. This change is a change in accounting estimate (the estimate being the life of the asset).

Changes in accounting estimate are accounted for in the current year and future years if the change affects both.

Choice "b" is incorrect. This answer is the annual difference between the depreciation expense IF depreciation expense had been retroactively restated ($\$24,000 / 8 = \$1,500$) and the correct depreciation expense. Retroactive restatement is not appropriate for changes in accounting estimate.

Choice "c" is incorrect. This answer is the depreciation expense IF depreciation had been retroactively restated ($\$24,000 / 8 = \$1,500$). Retroactive restatement is not appropriate for changes in accounting estimate.

Choice "d" is incorrect. This answer is the undepreciated amount at the beginning of the fifth year or the amount of the annual depreciation expense for each of the first 4 years. Either way, it certainly is not going to be the depreciation expense for that year because the remaining cost will be depreciated over the remaining period.

QUESTION 564

Envoy Co. manufactures and sells household products. Envoy experienced losses associated with its small appliance group. Operations and cash flows for this group can be clearly distinguished from the rest of Envoy's operations. Envoy plans to sell the small appliance group with its operations. What is the earliest point at which Envoy should report the small appliance group as a discontinued operation?

- A. When Envoy classifies it as held for sale.
- B. When Envoy receives an offer for the segment.
- C. When Envoy first sells any of the assets of the segment.
- D. When Envoy sells the majority of the assets of the segment.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The earliest period that a component of an entity can be reported in discontinued operations is when the component meets the following "held for sale" criteria:

1. Management commits to a plan to sell the component.
2. The component is available for immediate sale in its present condition.
3. An active program to locate a buyer has been initiated.
4. The sale of the component is probable and the sale is expected to be completed within one year.
5. The sale of the component is being actively marketed.
6. It is unlikely that significant change to the plan to sell will be made or that the plan will be withdrawn. Choices "b", "c", and "d" are incorrect, per the Explanation: above.

QUESTION 565

Belle Co. determined after four years that the estimated useful life of its labeling machine should be 10 years rather than 12 years. The machine originally cost \$46,000 and had an estimated salvage value of \$1,000. Belle uses straight-line depreciation. What amount should Belle report as depreciation expense for the current year?

- A. \$3,200
- B. \$3,750
- C. \$4,500
- D. \$5,000

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A change in estimated useful life is a change in accounting estimate, and is therefore accounted for prospectively. The revised useful life should be used as of the beginning of the year of the change and should be applied to the current book value of the fixed asset.

The first step in determining the depreciation expense in the year of the change in estimate is to determine the book value of the labeling machine at the time of the change:

Original cost \$46,000

- Accumulated depreciation 15,000 = $[(46,000 - 1,000) / 12] * 4$

Current book value \$31,000

This book value is then depreciated over the remaining life of the fixed asset based on the new estimated life. In this problem, the new estimated life is 10 years, four of which have already passed, so the asset must be depreciated over the remaining 6 years:

$(\$31,000 - 1,000) / 6 = \$5,000$

Choice "a" is incorrect. This answer is incorrectly calculated by adding the salvage value to the current book value, and by using the entire 10 year revised estimated life. Salvage value should always be subtracted and the asset should only be depreciated over the remaining life of the asset.

Choice "b" is incorrect. This is the annual depreciation before the change in estimated life $(\$46,000 - \$1,000) / 12 = \$3,750$. The depreciation after the change in estimate should be calculated as described above.

Choice "c" is incorrect. This would have been the annual straight-line depreciation if the original useful life of the asset had been 10 years rather than 12 years. The change in estimated life is applied prospectively, as described above, not retrospectively.

QUESTION 566

Rock Co.'s financial statements had the following balances at December 31:

Extraordinary gain	
Foreign currency translation gain, net of tax	
Net income	
Unrealized gain on available-for-sale securities, net of tax	

\$50,000
100,000
400,000
20,000

What amount should Rock report as comprehensive income for the year ended December 31?

- A. \$400,000
- B. \$420,000
- C. \$520,000
- D. \$570,000

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Comprehensive Income includes all items included in "Net Income" plus "Other Comprehensive Income" items. Since the \$50,000 extraordinary gain is already included in Net Income, Comprehensive Income is:

Net Income	\$400,000
"PUFE" adjustments:	
Foreign currency translation adj.	100,000
Unrealized gain on available-for-sale securities	20,000
	<u>\$520,000</u>

QUESTION 567

According to the FASB conceptual framework, comprehensive income includes which of the following?

	<i><u>Loss on discontinued operations</u></i>	<i><u>Investments by owners</u></i>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Comprehensive income is the change in equity of a business during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity except those resulting from investments by owners and distributions to owners. SFAC 6 para 70.

QUESTION 568 Which of the following describes how comprehensive income should be reported?

- A. Must be reported in a separate statement, as part of a complete set of financial statements.
- B. Should not be reported in the financial statements but should only be disclosed in the footnotes.
- C. May be reported in a separate statement, in a combined statement of income and comprehensive income, or within a statement of stockholders' equity.
- D. May be reported in a combined statement of income and comprehensive income or disclosed within a statement of stockholders' equity; separate statements of comprehensive income are not permitted.

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct.

Comprehensive income must be presented in one of three formats:

1. In a combined statement of income and comprehensive income;
2. In a separate statement of comprehensive income that begins with net income; or
3. In a statement of changes in equity.

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

QUESTION 569 What is the purpose of information presented in notes to the financial statements?

- A. To provide disclosures required by generally accepted accounting principles.
- B. To correct improper presentation in the financial statements.
- C. To provide recognition of amounts not included in the totals of the financial statements.
- D. To present management's responses to auditor comments.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Information presented in notes to the financial statements have the purpose of providing disclosures required by generally accepted accounting principles.

QUESTION 570 Which of the following should be disclosed in a summary of significant accounting policies?

- A. Basis of profit recognition on long-term construction contracts.
- B. Future minimum lease payments in the aggregate and for each of the five succeeding fiscal years.
- C. Depreciation expense.
- D. Composition of sales by segment.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The summary of significant accounting policies should disclose policies. The only policy in this question is the "basis" of profit recognition on long-term construction contracts. The other disclosures are accounting details and would be disclosed in other footnotes, but not in the summary of significant accounting policies.

Choice "b" is incorrect. The future minimum lease payments should be disclosed, but not in the summary of significant accounting policies.

Choice "c" is incorrect. Depreciation expense should certainly be disclosed, but not in the summary of significant accounting policies.

Choice "d" is incorrect. The composition of sales by segment should be disclosed, but not in the summary of significant accounting policies.

QUESTION 571

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.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The summary of significant accounting policies should include "policies." The only policy in the choices listed is the revenue recognition policies.

Choice "a" is incorrect. A description of current year equity transactions is not a policy. It should be disclosed somewhere in the footnotes but not in the summary of significant accounting policies.

Choice "b" is incorrect. A summary of long-term debt outstanding is not a policy. It should be disclosed somewhere in the footnotes but not in the summary of significant accounting policies. Choice

"c" is incorrect. A schedule of fixed assets is not a policy. It should be disclosed somewhere in the footnotes but not in the summary of significant accounting policies.

QUESTION 572

Which of the following is correct concerning financial statement disclosure of accounting policies?

- A. Disclosures should be limited to principles and methods peculiar to the industry in which the company operates.
- B. Disclosure of accounting policies is an integral part of the financial statements.
- C. The format and location of accounting policy disclosures are fixed by generally accepted accounting principles.
- D. Disclosures should duplicate details disclosed elsewhere in the financial statements.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Disclosure of accounting policies (and all other disclosure also) is an integral part of the financial statements.

Choice "a" is incorrect. For disclosure of accounting policies, disclosure should not be limited to principles and methods peculiar to the industry in which the company operates. All material accounting policies should be disclosed.

Choice "c" is incorrect. For disclosure of accounting policies, the format and location of accounting policies are not fixed by GAAP. Accounting policy disclosures are normally Note 1, but that is a (reasonable and very general) practice and not a "rule." It does make sense to disclose the "why" before the "what."

Choice "d" is incorrect. Disclosure of accounting policies should not duplicate details disclosed elsewhere in the financial statements.

QUESTION 573 Conceptually, interim financial statements can be described as emphasizing:

- A. Timeliness over reliability.
- B. Reliability over relevance.
- C. Relevance over comparability.
- D. Comparability over neutrality.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Interim financial statements emphasize timeliness (an element of relevance) by providing financial information based on actual performance to date and estimates prior to year end.

Information must be available when it is needed to be useful. Reliability is impeded by the extensive use of estimates; however, the lag until verifiability is obtained detracts from usefulness. SFAC 2 para. 56 Choice

"b" is incorrect. Relevance (particularly timeliness) of information in interim financial statements is emphasized more than reliability. Reliability is impeded by the extensive use of estimates in interim data.

Choice "c" is incorrect. Since comparability is a secondary quality of information, there should be no need to trade off comparability for relevance (a primary quality).

Choice "d" is incorrect. Neutrality is an element of reliability (a primary quality of information). There should be NO need for a trade-off for comparability over neutrality.

QUESTION 574

APB Opinion No. 28, Interim Financial Reporting, concluded that interim financial reporting should be viewed primarily in which of the following ways?

- A. As useful only if activity is spread evenly throughout the year.
- B. As if the interim period were an annual accounting period.
- C. As reporting for an integral part of an annual period.
- D. As reporting under a comprehensive basis of accounting other than GAAP.

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Interim financial reporting should be viewed as reporting for an integral part of an annual period. Choices

"a", "b", and "d" are incorrect, per the above rule.

QUESTION 575

During the first quarter of 1993, Tech Co. had income before taxes of \$200,000, and its effective income tax rate was 15%. Tech's 1992 effective annual income tax rate was 30%, but Tech expects its 1993 effective annual income tax rate to be 25%. In its first quarter interim income statement, what amount of income tax expense should Tech report?

- A. \$0
- B. \$30,000
- C. \$50,000
- D. \$60,000

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Interim period tax expense is the estimated annual effective tax rate (25% in this case) applied to the year-to-date income before taxes minus the tax expense recognized in previous interim periods. Since this question involves the first quarter, there are no previous interim periods. $25\% \times \$200,000 = \$50,000$. FIN 18, para. 16 Choice "a" is incorrect. Income tax expense is reported in interim income statements. Choice "b" is incorrect. The 1993 annual estimated tax rate, not the first quarter effective tax rate, is used to calculate income tax expense for interim statements. Choice "d" is incorrect. The 1993 annual estimated tax rate, not the 1992 annual effective tax rate, is used to calculate income tax expense for interim statements.

QUESTION 576

Due to a decline in market price in the second quarter, Petal Co. incurred an inventory loss. The market price is expected to return to previous levels by the end of the year. At the end of the year the decline had not reversed. When should the loss be reported in Petal's interim income statements?

- A. Ratably over the second, third, and fourth [sic] quarters.
- B. Ratably over the third and fourth quarters.
- C. In the second quarter only.
- D. In the fourth quarter only.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. When the loss is probable and estimable, the expected loss must be recorded in full. This loss becomes such at the end of the fourth quarter. Therefore, the inventory must be valued on the year-end at the lower of cost or market, recognizing the loss at that time.

Choice "a" is incorrect. Expected losses must be recorded in full when the loss is probable and estimable and not ratably over several quarters.

Choice "b" is incorrect. Expected losses must be recorded in full when the loss is probable and estimable and not ratably over several quarters. Choice

"c" is incorrect. Since the loss is not probable at the end of the second quarter, no amount should be recognized at that time.

QUESTION 577 In general, an enterprise preparing interim financial statements should:

- A. Defer recognition of seasonal revenue.
- B. Disregard permanent decreases in the market value of its inventory.
- C. Allocate revenues and expenses evenly over the quarters, regardless of when they actually occurred.
- D. Use the same accounting principles followed in preparing its latest annual financial statements.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Generally accepted accounting principles that were used in the most recent annual report of an enterprise should be applied to interim financial statements of the current year, unless a change in accounting principle is adopted in the current year.

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

QUESTION 578

During the first quarter of the calendar year, Worth Co. had income before taxes of \$100,000, and its effective income tax rate was 15%. Worth's effective annual income tax rate for the previous year was 30%. Worth expects that its effective annual income tax rate for the current year will be 25%. The statutory tax rate for the current year is 35%. In its first quarter interim income statement, what amount of income tax expense should Worth report?

- A. \$15,000
- B. \$25,000
- C. \$30,000
- D. \$35,000

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. When preparing interim financial statements, income tax expense is estimated each quarter using the effective tax rate expected to apply to the entire year.
 Choice "a" is incorrect. Worth should use the effective annual tax rate, not the effective tax rate for the quarter only.
 Choice "c" is incorrect. Worth should use the effective annual tax rate expected to apply to the current year, not the prior year's effective tax rate. Choice
 "d" is incorrect. Worth should use the effective annual tax rate, not the statutory tax rate.

QUESTION 579

Terra Co.'s total revenues from its three operating segments were as follows:

<i>Segment</i>	<i>Sales to unaffiliated customers</i>	<i>Intersegment sales</i>	<i>Total revenues</i>
Lion	\$ 70,000	\$ 30,000	\$ 100,000
Monk	22,000	4,000	26,000
Nevi	8,000	16,000	24,000
Combined	\$ 100,000	\$ 50,000	\$ 150,000
Elimination	-	(50,000)	(50,000)
Consolidated	<u>\$ 100,000</u>	<u>\$ -</u>	<u>\$ 100,000</u>

Which operating segment(s) is (are) deemed to be reportable segments?

- A. None.
- B. Lion only.
- C. Lion and Monk only.
- D. Lion, Monk, and Nevi.



Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A reportable operating segment is one having 10% of all revenue, including revenue from unaffiliated sales and from intersegment sales:

Lion's revenue percentage is 66.7% [$\$100,000/\$150,000$].

Monk's revenue percentage is 17.3% [$\$26,000/\$150,000$].

Nevi's revenue percentage is 16% [$\$24,000/\$150,000$].

Thus, all three segments meet the 10% of total revenues test and are reportable as operating segments. SFAS 14 para. 10 and 15 as amended by SFAS 131 Choice

"a" is incorrect. All segments with revenue percentages exceeding 10% of total revenues are reportable operating segments.

Choice "b" is incorrect. Lion is not the only segment with revenue percentages exceeding 10% of total revenues. Choice

"c" is incorrect. Nevi has a revenue percentage exceeding 10% of total revenues.

QUESTION 580

What information should a public company present about revenues from its reporting segments?

- A. Disclose separately the amount of sales to unaffiliated customers and the amount of intracompany sales.
- B. Disclose as a combined amount sales to unaffiliated customers and intracompany sales between geographic areas.
- C. Disclose separately the amount of sales to unaffiliated customers but not the amount of intracompany sales between geographic areas.
- D. No disclosure of revenues from foreign operations need be reported.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Unaffiliated customers sales and intracompany sales must be disclosed separately.

QUESTION 581

Taft Corp. discloses supplemental industry segment information. The following information is available for 1992:

<u>Segment</u>	<u>Sales</u>	<u>Traceable operating expenses</u>
A	\$ 20,000	\$ 12,000
B	16,000	10,000
C	12,000	7,000
	<u>\$ 48,000</u>	<u>\$ 29,000</u>

Additional 1992 expenses, not included above, are as follows:

Indirect operating expenses \$7,200

General corporate expenses 4,800

Segment C's 1992 operating profit was:

- A. \$5,000
- B. \$3,200
- C. \$2,600
- D. \$2,000

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. \$5,000 operating profit for Segment C.

Rule: Operating profit by segments is based on the measure of profit reported to the "Chief Operating Decision Maker."

Interest expense, income taxes, and general corporate expenses are not allocated to the divisions solely for the purposes of segment disclosures; they may be allocated if that is how the segments report to the "Chief Operating Decision Maker."

Segment C's sales	\$12,000
Less traceable operating expenses	(7,000)
Segment C operating profit	<u>\$ 5,000</u>

QUESTION 582

In financial reporting of segment data, which of the following items is always used in determining a segment's operating income?

- A. Income tax expense.
- B. Sales to other segments.
- C. General corporate expense.
- D. Gain or loss on discontinued operations.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Sales to other segments would be used in determining a segment's operating income.

Rule: Equity in net income of another company, general corporate expenses, interest, income tax expense, and gains or losses on discontinued operations are all not included in segment profit unless they are included in the determination of segment profit reported to the "Chief Operating Decision Maker."

QUESTION 583

Opto Co. is a publicly-traded, consolidated enterprise reporting segment information. Which of the following items is a required enterprise-wide disclosure regarding external customers?

- A. The fact that transactions with a particular external customer constitute more than 10% of the total enterprise revenues.
- B. The identity of any external customer providing 10% or more of a particular operating segment's revenue.
- C. The identity of any external customer considered to be "major" by management.
- D. Information on major customers is not required in segment reporting.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. In order to conform to GAAP, financial statements for public business enterprises must report segment information about a company's major customers if that customer provides 10% or more of the combined revenue, internal and external, of all operating segments.

Choice "b" is incorrect. Revenue is 10% of ALL operating segments not "a particular" segment.

Choice "c" is incorrect. Disclosure is not at management's discretion. Choice "d" is incorrect.

Disclosure is required.

QUESTION 584 Which of the following qualifies as an operating segment?

- A. Corporate headquarters, which oversees \$1 billion in sales for the entire company.
- B. North American segment, whose assets are 12% of the company's assets of all segments, and management reports to the chief operating officer.
- C. South American segment, whose results of operations are reported directly to the chief operating officer, and has 5% of the company's assets, 9% of revenues, and 8% of the profits.
- D. Eastern Europe segment, which reports its results directly to the manager of the European division, and has 20% of the company's assets, 12% of revenues, and 11% of profits.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Assets of the North American segment exceed 10% combined assets of all operating segments.

Choice "a" is incorrect. Corporate headquarters is not considered a segment.

Choice "c" is incorrect. The South American segment does not meet any of the 10% minimums (Revenue, P&L or Assets). Choice

"d" is incorrect. Eastern Europe segment does not report to the chief operating officer.

QUESTION 585

Which of the following should be disclosed for each reportable operating segment of an enterprise?

<u>Profit or loss</u>	<u>Total assets</u>
Yes	Yes
Yes	No
No	Yes
No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. For each reportable segment of an enterprise, both profit or loss and total assets should be disclosed. In disclosure questions, if you are not sure, disclose the most rather than the least.

Choice "b" is incorrect. For each reportable segment of an enterprise, both profit or loss and total assets should be disclosed. Choice "c" is incorrect. For each reportable segment of an enterprise, both profit or loss and total assets should be disclosed.

Choice "d" is incorrect. For each reportable segment of an enterprise, both profit or loss and total assets should be disclosed.

QUESTION 586

Which of the following factors determines whether an identified segment of an enterprise should be reported in the enterprise's financial statements under SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information?

- I. The segment's assets constitute more than 10% of the combined assets of all operating segments.
- II. The segment's liabilities constitute more than 10% of the combined liabilities of all operating segments.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation



Explanation/Reference:

Explanation:

Choice "a" is correct. For segment reporting, if an identified segment's assets constitute more than 10% of the combined assets of all operating segments, the segment should be reported. The same rule does not apply for the segment's liabilities. The candidate does have to remember the 10% and also the 10% of "what."

Choice "b" is incorrect. For segment reporting, if an identified segment's assets constitute more than 10% of the combined assets of all operating segments, the segment should be reported. The same rule does not apply for the segment's liabilities.

Choice "c" is incorrect. For segment reporting, if an identified segment's assets constitute more than 10% of the combined assets of all operating segments, the segment should be reported. The same rule does not apply for the segment's liabilities, so the correct answer cannot be "Both."

Choice "d" is incorrect. For segment reporting, if an identified segment's assets constitute more than 10% of the combined assets of all operating segments, the segment should be reported. The correct answer cannot be "Neither."

QUESTION 587 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.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Only publicly-traded enterprises are required to report on business segments.

Choices "a", "c", and "d" are incorrect, per the Explanation: above.

QUESTION 588

In financial reporting of segment data, which of the following must be considered in determining if an industry segment is a reportable segment?

	<u><i>Sales to unaffiliated customers</i></u>	<u><i>Intersegment sales</i></u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A segment is considered reportable if its reported revenue, including sales to unaffiliated customers and intersegment sales, is 10% or more of the combined revenue (unaffiliated and intersegment) of all operating segments.

Choices "b", "c", and "d" are incorrect, per the above Explanation: .

QUESTION 589

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

	<u><i>Revenue recognition</i></u>	<u><i>Deferral of expenses</i></u>
A.	Yes	Yes
B.	Yes	No
C.	No	No
D.	No	Yes

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Development stage enterprises must use all the same principles as established enterprises including those of revenue recognition and deferral of expenses. The primary difference is that development stage enterprises must provide additional disclosures not required of established operating enterprises.

QUESTION 590

Tanker Oil Co., a development stage enterprise, incurred the following costs during its first year of operations:

Legal fees for incorporation and other related matters	55,000
Underwriters' fees for initial stock offering	40,000
Exploration costs and purchases of mineral rights	60,000

Tanker had no revenue during its first year of operation. What amount may Tanker capitalize as organizational costs?

- A. \$115,000
- B. \$95,000
- C. \$55,000
- D. \$0

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:



*Capitalize as
organizational
costs*

Legal fees for incorporation and other related matters should be expensed as start-up costs	-
Underwriting fees for initial stock offering should be recorded as a reduction of contributed capital	-
Exploration costs should be expensed as research & development	-
Purchases of mineral rights should be capitalized as fixed assets	-
Capitalize as organizational costs	<u>0</u>

Choice "d" is correct. \$0.

All organizational costs (start-up costs) should be expensed when incurred (per SOP 98-5).

QUESTION 591 Which of the following statements regarding fair value is/are correct?

- I. The fair value of an asset or liability is specific to the entity making the fair value measurement.
- II. Fair value is the price to acquire an asset or assume a liability.
- III. Fair value includes transportation costs, but not transaction costs.

IV. The price in the principal market for an asset or liability will be the fair value measurement.

- A. I & II
- B. I & IV
- C. II & III
- D. III & IV

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Statements III and IV are correct. Statement I is incorrect because fair value is a market-specific measure, not an entity-specific measure. Statement II is incorrect because fair value is an exit price (the price to sell an asset or transfer a liability), not an entrance price.

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

QUESTION 592

Which of the following is not a valuation technique that can be used to measure the fair value of an asset or liability?

- A. The market approach.
- B. The impairment approach.
- C. The income approach.
- D. The cost approach.

Correct Answer: B

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. The impairment approach is not used to measure the fair value of an asset or liability. Instead, when an entity is determining whether an asset has been impaired, the entity will use the market approach, the income approach or the cost approach to determine the fair value of the asset.

Choice "a" is incorrect. The market approach is an accepted method of fair value measurement in which price and other market information from identical or comparable assets or liabilities is used to measure fair value.

Choice "c" is incorrect. The income approach is an accepted method of fair value measurement in which future cash flows or earnings are discounted to determine fair value.

Choice "d" is incorrect. The cost approach is an accepted method of fair value measurement in which current replacement cost is used to determine the fair value of an asset.

QUESTION 593

Which of the following statements is incorrect regarding the inputs that can be used to measure fair value?

- I. Level I inputs are the most reliable fair value measurements and Level III inputs are the least reliable.
- II. Level I measurements are quoted prices in active markets for identical or similar assets or liabilities.
- III. A fair value measurement based on management assumptions only (no market data) would not be acceptable per GAAP.
- IV. The level in the fair value hierarchy of a fair value measurement is determined by the level of the highest level significant input.

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

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Statement I is correct and statements II, III, and IV are incorrect. Statement II is incorrect because Level I measurements are quoted prices in active markets for identical assets or liabilities only. Quoted prices in active markets for similar assets or liabilities are Level II inputs.

Statement III is incorrect because a fair value measurement based on management assumptions only is a Level III measurement and is acceptable when there are no Level I or Level II inputs or when undo cost or effort is required to obtain Level I or Level II inputs. Statement IV is incorrect because the level in the fair value hierarchy of a fair value measurement is determined by the level of the lowest level significant input.

QUESTION 594

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
- B. \$72
- C. \$74
- D. \$76

Correct Answer: C

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

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 595

A change from the cost approach to the market approach of measuring fair value is considered to be what type of accounting change?

- A. Change in accounting estimate.
- B. Change in accounting principle.
- C. Change in valuation technique.
- D. Error correction.

Correct Answer: A

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. A change in the valuation technique used to measure fair value is a change in accounting estimate.

Choice "b" is incorrect. Per SFAS No. 157, a change in valuation technique is a change in accounting estimate, not a change in accounting principal.

Choice "c" is incorrect. Although a change from the cost approach to the market approach is a change in valuation technique, a change in valuation technique is not defined as a type of accounting change, but instead falls into the category of changes in accounting estimate.

Choice "d" is incorrect. Both the market approach and the cost approach are acceptable methods of measuring fair value per SFAS No. 157; therefore, switching between these methods is not the correction of an error. Additionally, an error correction is not a type of accounting change.

QUESTION 596

According to the FASB conceptual framework, the objectives of financial reporting for business enterprises are based on:

- A. The need for conservatism.
- B. Reporting on management's stewardship.
- C. Generally accepted accounting principles.
- D. The needs of the users of the information.

Correct Answer: D

Section: Financial Accounting and Reporting

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. The FASB conceptual framework states that the objectives of financial reporting stem from the informational needs of the external users of the information. SFAC 1 para. 28

Choice "a" is incorrect. Conservatism is an underlying concept for financial accounting but is not the basis for the objectives. SFAC 2 para. 91-97

Choice "b" is incorrect. Information concerning management's stewardship is only one aspect of the information financial statements are intended to provide. SFAC 1 para. 50

Choice "c" is incorrect. Generally accepted accounting principles (GAAP) are derived from and based on the objectives of financial reporting, not the other way around.

QUESTION 597 Parker, whose spouse died during the preceding year, has not remarried. Parker maintains a home for a dependent child. What is Parker's most advantageous filing status?

- A. Single.
- B. Head of household.
- C. Married filing separately.
- D. Qualifying widow(er) with dependent child.



Correct Answer: D

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. A qualifying widow(er) is a taxpayer who may use the joint tax return standard deduction and rates (but not the exemption for the deceased spouse) for each of two taxable years following the year of death of his or her spouse, unless he or she remarries. The surviving spouse must maintain a household that, for the whole entire taxable year, was the principal place of abode of a son, stepson, daughter, or stepdaughter (whether by blood or adoption). The surviving spouse must also be entitled to a dependency exemption for such individual. Parker may file as a qualifying widow(er) since her spouse died in the previous tax year, she did not remarry and she maintained a home for a dependent child. Since, qualifying widow(er) is the most advantageous status and Parker qualifies, Parker would file as a qualifying widow(er).

Choice "a" is incorrect. Even though Parker would qualify as single, filing single would give Parker a high tax liability than the qualifying widow(er) status and therefore is not most advantageous.

Choice "b" is incorrect. Parker would not qualify as head of household for the first two years after the death of Parker's spouse because one of the requirements for Head of Household status is that the taxpayer is NOT a surviving spouse.

(Also, note that the likely reason for this requirement is that filing as Head of Household status would give the qualifying surviving spouse taxpayer a higher tax liability than the Qualifying Widow(er) status, which would be less advantageous.)

Choice "c" is incorrect. Parker would not qualify to file married filing separately.

QUESTION 598 In which of the following situations may taxpayers file as married filing jointly?

- A. Taxpayers who were married but lived apart during the year.
- B. Taxpayers who were married but lived under a legal separation agreement at the end of the year.
- C. Taxpayers who were divorced during the year.
- D. Taxpayers who were legally separated but lived together for the entire year.

Correct Answer: A

Section: Regulation**Explanation****Explanation/Reference:**

Explanation:

RULE: In order to file a joint return, the parties must be MARRIED at the end of the year. Exception: If the parties are married but are LEGALLY SEPARATED under the laws of the state in which they reside, they cannot file a joint return (they will file either under the single or head of household filing status).

Choice "a" is correct. Per the above rule, taxpayers who are married but lived apart during the year are allowed to file a joint return for the year. The fact that they did not live together during the year has no bearing on the issue.

Choice "b" is incorrect. Per the above rule, taxpayers who are married but lived under a legal separation agreement at the end of the year may not file a joint return. They will generally file either under the single or head of household filing status.

Choice "c" is incorrect. Per the above rule, taxpayers who were divorced during the year may not file a joint return together, as they are not married at the end of the year. [Note, however, that they may become married again in the year and file a joint return with the new spouse.]

Choice "d" is incorrect. Per the above rule, taxpayers who were legally separated but lived together for the entire year may not file a joint return. They will generally file either under the single or head of household filing status.

QUESTION 599

Barkley owns a vacation cabin that was rented to unrelated parties for 10 days during the year for \$2,500. The cabin was used personally by Barkley for three months and left vacant for the rest of the year. Expenses for the cabin were as follows:

Real estate taxes \$1,000

Maintenance and utilities \$2,000

How much rental income (loss) is included in Barkley's adjusted gross income?

- A. \$0
- B. \$500
- C. \$(500)
- D. \$(1,500)

Correct Answer: A

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

RULE: If a vacation residence is rented for less than 15 days per year, it is treated as a personal residence. The rental income is excluded from income, and mortgage interest (first or second home) and real estate taxes are allowed as itemized deductions. Depreciation, utilities, and repairs are not deductible.

Choice "a" is correct. Applying the rule above, if a vacation residence is rented for less than 15 days per year, it is treated as a personal residence. The rental income (\$2,500 in this case) is excluded from income. A Schedule E is not filed for this property (i.e., no income is reported, the taxes are reported as itemized deductions, and the maintenance and utilities are not deductible), so the effect on AGI is zero.

Choice "b" is incorrect. This assumes that the property taxes are reported as itemized deductions but that the rental income (\$2,500) less the maintenance and utilities (\$2,000) are reported net on Schedule E.

Per the above RULE, the rental income is excluded from income, and the maintenance and utilities are not deductible.

Choice "c" is incorrect. This assumes that all of the items shown are reported net on the Schedule E - $\$2,500 - \$1,000 - \$2,000 = (\$500)$. Per the above RULE, the rental income is excluded from income, the maintenance and utilities are not deductible, and the property taxes are reported on Schedule A as an itemized deduction. Choice "d" is incorrect, per the above rule and discussion.

QUESTION 600

In evaluating the hierarchy of authority in tax law, which of the following carries the greatest authoritative value for tax planning of transactions?

- A. Internal Revenue Code.
- B. IRS regulations.
- C. Tax court decisions.
- D. IRS agents' reports.

Correct Answer: A

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. According to the IRS's website under Tax Code, Regulations and Official Guidance, the "federal tax law begins with the Internal Revenue Code (IRC), [which was] enacted by Congress in Title 26 of the United States Code (26 U.S.C.)." The IRC holds the most authoritative value.

Choice "b" is incorrect. According to the IRS's website under Tax Code, Regulations and Official Guidance, the IRS regulations or "Treasury regulations (26 C.F.R.)-commonly referred to as Federal tax regulations-pick up where the Internal Revenue Code (IRC) leaves off by providing the official interpretation of the IRS by the U.S. Department of Treasury." Regulations give directions on how to apply the law outlined in the Internal Revenue Code. Regulations have the second most force and effect, second only to the IRC.

Choice "c" is incorrect. Tax court decisions interpret the Internal Revenue Code. They do not have the authority of the IRC.

Choice "d" is incorrect. The reports of IRS agents are used to report on specific taxpayer situations. IRS agents' reports apply the Internal Revenue Code, IRS regulations, and other forms of authoritative literature, but they do not hold the value that the IRC, the IRS regulations, or even tax court decisions have.

QUESTION 601

In 19X4, Smith, a divorced person, provided over one half the support for his widowed mother, Ruth, and his son, Clay, both of whom are U.S. citizens. During 19X4, Ruth did not live with Smith. She received \$9,000 in Social Security benefits. Clay, a 25 year-old full-time graduate student, and his wife lived with Smith. Clay had no income but filed a joint return for 19X4, owing an additional \$500 in taxes on his wife's income. How many exemptions was Smith entitled to claim on his 19X4 tax return?

- A. 4
- B. 3
- C. 2
- D. 1

Correct Answer: C

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Smith is entitled to an exemption for himself. He is also entitled to an exemption for his mother Ruth (qualifying relative). Ruth has \$9,000 in Social Security payments during 19X4, but since that is her only income, the Social Security is not taxable, and nontaxable income does not count in calculating whether an exemption can be taken for a dependent. Clay cannot be taken as a dependent because he filed a joint return with his wife. Since the joint return was filed for a purpose other than simply claiming a refund, the joint return prevents Smith from claiming an exemption for Clay. An exemption cannot be taken for Clay's wife because she filed a joint return with Clay. Smith is entitled to two exemptions.

Choice "a" is incorrect. Clay cannot be taken as a dependent because he filed a joint return with his wife. Since the joint return was filed for a purpose other than simply claiming a refund, the joint return prevents Smith from claiming an exemption for Clay. An exemption cannot be taken for Clay's wife because she filed a joint return with Clay.

Choice "b" is incorrect. Clay cannot be taken as a dependent because he filed a joint return with his wife. Since the joint return was filed for a purpose other than simply claiming a refund, the joint return prevents Smith from claiming an exemption for Clay. An exemption cannot be taken for Clay's wife because she filed a joint return with Clay.

Choice "d" is incorrect. Smith is entitled to an exemption for his mother, Ruth. Ruth has \$9,000 in Social Security payments during 19X4, but because that is her only income, the Social Security income is not taxable, and nontaxable income does not count in calculating whether an exemption can be taken for a dependent.

QUESTION 602

Darr, an employee of Sorce C corporation, is not a shareholder. Which of the following would be included in a taxpayer's gross income?

- A. Employer-provided medical insurance coverage under a health plan.
- B. A \$10,000 gift from the taxpayer's grandparents.
- C. The fair market value of land that the taxpayer inherited from an uncle.
- D. The dividend income on shares of stock that the taxpayer received for services rendered.

Correct Answer: D

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. An individual receiving common stock for services rendered must recognize the fair market value as ordinary income. Any dividends received on that stock would also result in income recognition.

Choice "a" is incorrect. Employer-provided medical insurance is a tax-free fringe benefit.

Choices "b" and "c" are incorrect. Gifts and inheritances are both tax-free to the recipient. (Remember tax is often paid by the person giving the gift or the estate at death.)

QUESTION 603

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

- A. Depreciation may not be deducted on the property under any circumstances.

- B. A rental loss may be deducted if rental-related expenses exceed rental income.
- C. Utilities and maintenance on the property must be divided between personal and rental use.
- D. All mortgage interest and taxes on the property will be deducted to determine the property's net income or loss.

Correct Answer: C

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

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

All related expenses must be prorated between the personal use portion and the rental activity portion. Prorated depreciation is permitted for the rental activity.

QUESTION 604

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

Correct Answer: D

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Baum should report \$281,750 as 1999 net earnings from self-employment (line 12 of the Form 1040), calculated as follows:

Gross business receipts	\$350,000
Cost of goods sold	(35,000)
Rent expense	(28,000)
Liability insurance premium	(5,250)
Net earnings on Schedule C	<u>\$281,750</u>

Choices "a", "b", and "c" are incorrect. Self-employment tax and self-employment health insurance expenses are adjustments from total gross income. They are not deducted from self-employment earnings (i.e., not reported net on line 12 of the Form 1040).

Note: There are many distracters in this question, all relating to items that are either deductible as part of itemized deductions or not deductible. Be careful to read the requirement of the question before spending unnecessary time on the question. The statement that Baum's year-end inventory was not subject to the uniform capitalization rules is a distracter as well. There is not enough information given in the facts to apply the rules if he had been subject to them.

QUESTION 605

On December 1, 1997, Krest, a self-employed cash basis taxpayer, borrowed \$200,000 to use in her business. The loan was to be repaid on November 30, 1998. Krest paid the entire interest amount of \$24,000 on December 1, 1997. What amount of interest was deductible on Krest's 1997 income tax return?

- A. \$0
- B. \$2,000
- C. \$22,000 D. \$24,000

Correct Answer: B

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Cash basis taxpayers deduct interest in the year paid or the year to which the interest relates, whichever is later. Even though all of the interest on this loan was paid on December 1, 1997, only the interest relating to December 1997 can be deducted in 1997. The question does not give an interest rate, but because the loan is to be repaid in a lump sum at maturity, 1/12 of the interest, or \$2,000 applies to each month.

Choice "a" is incorrect. Because \$2,000 of the interest relates to 1997, this amount is deductible in 1997.

Choice "c" is incorrect. This is the amount that cannot be deducted until 1998, the year to which the interest relates. Be sure to read questions like this very carefully, because if you had simply misread the question as seeking the amount deductible in 1998, you would get the question wrong despite understanding the rule.

Choice "d" is incorrect. Cash basis taxpayers can deduct interest in the year paid or the year to which the interest relates, whichever is later, thus 11 months of the interest will not be deductible until 1998.

QUESTION 606 Which payment(s) is(are) included in a recipient's gross income?

- I. Payment to a graduate assistant for a part-time teaching assignment at a university. Teaching is not a requirement toward obtaining the degree.
- II. A grant to a Ph.D. candidate for his participation in a university-sponsored research project for the benefit of the university.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

Correct Answer: C

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct.

I. A payment to a student for a part-time teaching assignment is taxable income just as a payment for any other campus job would be. This is not a scholarship or fellowship. II. There is no exclusion in the tax law for amounts paid to a degree candidate for participation in university-sponsored research.

QUESTION 607

Under the uniform capitalization rules applicable to property acquired for resale, which of the following costs should be capitalized with respect to inventory if no exceptions are met?

	<u>Marketing costs</u>	<u>Off-site storage costs</u>
A.	Yes	Yes
B.	Yes	No
C.	No	No
D.	No	Yes

- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: D
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. Under the uniform capitalization rules, purchasers of inventory for resale may deduct their marketing costs but must capitalize their off-site storage costs. Choices "a", "b", and "c" are incorrect. Marketing costs are deductible, but off-site storage must be capitalized.

QUESTION 608

In a tax year where the taxpayer pays qualified education expenses, interest income on the redemption of qualified U.S. Series EE Bonds may be excluded from gross income. The exclusion is subject to a modified gross income limitation and a limit of aggregate bond proceeds in excess of qualified higher education expenses. Which of the following is (are) true?

- I. The exclusion applies for education expenses incurred by the taxpayer, the taxpayer's spouse, or any person whom the taxpayer may claim as a dependent for the year.
- II. "Otherwise qualified higher education expenses" must be reduced by qualified scholarships not includible in gross income.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

Correct Answer: C
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Interest earned on Series EE bonds issued after 1989 may qualify for exclusion. One requirement is that the interest is used to pay tuition and fees for the taxpayer, spouse, or dependent enrolled in higher education. The interest exclusion is reduced by qualified scholarships that are exempt from tax and other nontaxable payments received for educational expenses (other than gifts and inheritances).

QUESTION 609 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

Correct Answer: A
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Interest income from U.S. obligations is generally taxable. Interest income on a federal tax refund is taxable, even though the refund itself is not taxed.

Choice "b" is incorrect. Interest income on a federal tax refund is taxable, even though the refund itself is not taxed. Choice "c" is incorrect. Interest income from U.S. obligations is generally taxable.

Choice "d" is incorrect. Interest income from U.S. obligations is generally taxable. Interest income on a federal tax refund is taxable, even though the refund itself is not taxed.

QUESTION 610

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



Correct Answer: A
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Deductions to arrive at net self-employed income include all necessary and ordinary expenses connected with the business. Estimated federal income tax payments are not an expense. Charitable contributions by an individual are only deductible as an itemized deduction on Schedule A. This assumes the contribution was not made with the "expectation of commensurate financial return."

Receipts	\$20,000
Parts	(2,500)
Listing	(2,000)
Telephone	(400)
Net self-employment income	<u>\$15,100</u>

Choice "b" is incorrect. Charitable contributions are an itemized deduction unless there is an expectation of commensurate financial return. Choice

"c" is incorrect. Federal income taxes paid are not a deductible expense.

Choice "d" is incorrect. Charitable contributions are an itemized deduction unless there is an expectation of commensurate financial return. Federal income taxes paid are not a deductible expense.

QUESTION 611

On December 1, 1992, Michaels, a self-employed cash basis taxpayer, borrowed \$100,000 to use in her business. The loan was to be repaid on November 30, 1993. Michaels paid the entire interest of \$12,000 on December 1, 1992. What amount of interest was deductible on Michaels' 1993 income tax return?

- A. \$12,000

- B. \$11,000
- C. \$1,000
- D. \$0

Correct Answer: B
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Prepaid interest must be prorated over the time for which payment is made. This is true for both cash and accrual basis taxpayers. The loan is for 1 month in 1992 and 11 months in 1993. Therefore, 1/12 of the interest is deductible in 1992 and 11/12, or \$11,000 is deductible in 1993.

Choices "a", "c", and "d" are incorrect. Prepaid interest must be prorated over the time for which payment is made. This is true for both cash and accrual basis taxpayers.

QUESTION 612

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

Correct Answer: D
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "d" is correct. There is no income tax on the value of inherited property. The gain on the sale is the difference between the sales price of \$4,500 and Hall's basis. Hall's basis is the alternate valuation elected by the executor. This is the value 6 months after date of death or date distributed if before 6 months. The property was distributed 4 months after death and the value that day (\$4,500) is used for the basis. $\$4,500 - \$4,500 = 0$.

Choice "a" is incorrect. There is no income tax on the value of inherited property.

Choice "b" is incorrect. This is the basis of the stock if the alternate date had not been used. Heirs are not taxed on inheritances. The income or loss results when inherited property is sold.

Choice "c" is incorrect. There is no income tax on the value of inherited property. The gain on the sale is the difference between the sales price of \$4,500 and Hall's basis. Hall's basis is the alternate valuation elected by the executor.

QUESTION 613

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

Correct Answer: B
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "b" is correct. Alimony would be income to Mary while child support would not. Funds qualify as child support only if 1) a specific amount is fixed or is contingent on the child's status (e.g., reaching a certain age), 2) it is paid solely for the support of minor children, and 3) it is payable by decree, instrument or agreement. The actual use of the funds is irrelevant to the issue. In this case, \$2,000 ($20\% \times \$10,000$) qualifies as child support. The other \$8,000 is alimony, which would be income to Mary.

Choice "a" is incorrect. Take 80% of the \$10,000 paid, not 80% of the \$7,000 received by Mary.

Choice "c" is incorrect. Only \$8,000 would be alimony per the divorce decree ($80\% \times \$10,000$).

Choice "d" is incorrect. The 20% reduction when the child turns 18 makes 20% of the \$10,000 payment, or \$2,000, child support, which is nontaxable to Mary.

QUESTION 614 Freeman, a single individual, reported the following income in the current year:

Guaranteed payment from services rendered to a partnership \$50,000
Ordinary income from a S corporation \$20,000

What amount of Freeman's income is subject to self-employment tax?

- A. \$0
- B. \$20,000
- C. \$50,000
- D. \$70,000

Correct Answer: C

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Guaranteed payments are reasonable compensation paid to a partner for services rendered (or use of capital) without regard to his ratio of income. Earned compensation is subject to self-employment tax. Payments not guaranteed are merely another way to distribute partnership profits. The ordinary income reported from an S corporation are taxable income to the individual or their own individual tax return but is not subject to self-employment tax. The ordinary income reported from a partnership may be subject to self-employment tax (if to a general partner).

QUESTION 615

During 2001, Adler had the following cash receipts:

Wages	\$18,000
Interest Income from investments in municipal bonds	400
Unemployment compensation	1,500

What is the total amount that must be included in gross income on Adler's 2001 income tax return?

- A. \$18,000
- B. \$18,400
- C. \$19,500
- D. \$19,900

Correct Answer: C

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The wages of \$18,000 and unemployment compensation are both includable in gross income on Adler's 2001 income tax return.

Choice "a" is incorrect. The unemployment compensation must be included in gross income.

Choice "b" is incorrect. Municipal bond interest income is excluded from gross income and the unemployment compensation must be included in gross income. Choice

"d" is incorrect. Municipal bond interest income is excluded from gross income.

QUESTION 616

DAC Foundation awarded Kent \$75,000 in recognition of lifelong literary achievement. Kent was not required to render future services as a condition to receive the \$75,000. What condition(s) must have been met for the award to be excluded from Kent's gross income?

- I. Kent was selected for the award by DAC without any action on Kent's part.
- II. Pursuant to Kent's designation, DAC paid the amount of the award either to a governmental unit or to a charitable organization.

- A. I only.
- B. II only.
- C. Both I and II.

D. Neither I nor II.

Correct Answer: C
Section: Regulation
Explanation

Explanation/Reference:

Explanation:
 Choice "c" is correct. Generally, the fair market value of prizes and awards is taxable income. However, an exclusion from income for certain prizes and awards applies where the winner is selected for the award without entering into a contest (i.e., without any action on their part) and then assigns the award directly to a governmental unit or charitable organization. Therefore, conditions "I" and "II" must be met in order for Ken to exclude the award from his gross income.
 Choice "a" is incorrect. "II" is a necessary condition as well. See explanation above.
 Choice "b" is incorrect. "I" is a necessary condition as well. See explanation above.
 Choice "d" is incorrect. "I" and "II" are both necessary conditions. See explanation above.

QUESTION 617

Mosh, a sole proprietor, uses the cash basis of accounting. At the beginning of the current year, accounts receivable were \$25,000. During the year, Mosh collected \$100,000 from customers. At the end of the year, accounts receivable were \$15,000. What was Mosh's gross taxable income for the current year?

- A. \$75,000
- B. \$90,000
- C. \$100,000
- D. \$110,000

Correct Answer: C
Section: Regulation
Explanation

Explanation/Reference:

Explanation:
 Choice "c" is correct. The facts state that cash collections from customers were \$100,000 and as a cash basis taxpayer this is the amount of Mosh's gross taxable income for the year. Note that according to the formula BASE - we can determine the amount of sales = \$90,000, but that would give us accrual, not cash basis, income.

Beginning A/R	\$ 25,000	
Add - Sales	<u>90,000</u>	accrual basis taxable income
	115,000	
Subtract - Cash collections	<u>(100,000)</u>	cash basis taxable income
Ending A/R	\$ 15,000	

Choice "a" is incorrect. See explanation above.
 Choice "b" is incorrect. \$90,000 is the amount of sales that would be Mosh's taxable income if Mosh were an accrual basis taxpayer. Choice "d" is incorrect. See explanation above.

QUESTION 618

Porter was unemployed for part of the year. Porter received \$35,000 of wages, \$4,000 from a state unemployment compensation plan, and \$2,000 from his former employer's company-paid supplemental unemployment benefit plan. What is the amount of Porter's gross income?

- A. \$35,000
- B. \$37,000
- C. \$39,000
- D. \$41,000

Correct Answer: D
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

RULE: Gross income includes all income unless it is specifically excluded in the tax code.

Choice "d" is correct. Wages and all unemployment compensation are not excluded from being taxable; therefore, there are included in the taxpayer's gross income for tax purposes.

Wages received	\$35,000
State unemployment compensation	4,000
Employer's unemployment compensation plan	<u>2,000</u>
	<u>\$41,000</u>

Choice "a" is incorrect. All forms of unemployment compensation are included as part of gross income. Choice "b" is incorrect. The \$4,000 of state unemployment compensation received is included as part of gross income. Choice "c" is incorrect. The \$2,000 of his former employer's company-paid supplemental unemployment benefit plan is included as part of gross income.

QUESTION 619 Which one of the following will result in an accrual expense for an accrual-basis taxpayer?

- A. An invoice dated prior to year end but the repair completed after year end.
- B. A repair completed prior to year end but not invoiced.
- C. A repair completed prior to year end and paid upon completion.
- D. A signed contract for repair work to be done and the work is to be completed at a later date.

Correct Answer: B

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

RULE: An accrual expense is one that the services have been received/performed but have not been paid for by the end of the reporting period.

Choice "b" is correct. The facts indicate that a repair was completed prior to year end but not yet invoiced. If it has not yet been invoiced, it is assumed that it has also not yet been paid for. Therefore, this is a situation in which the repair expense would be accrued at year end. Services have been performed, but they have not been paid for, as they have not even been invoiced yet.

Choice "a" is incorrect. If the repair was completed after year end, then the expense is not accrual, as the benefit of the services hasn't been received as of year end. The fact that the repair was invoiced prior to year end does not impact the situation.

Choice "c" is incorrect. If a repair was completed and paid for prior to year end, no accrual is appropriate. On the accrual basis, the expense is taken in the year the repair is completed and the benefit is received. In this case, the account payable was also paid in the same year, but this has no effect on the expense.

Choice "d" is incorrect. The facts indicate that the work is to be completed at a date later than year end. Therefore, the expense is not accrual at year end, as the benefit of the repair hasn't been received as of year end. It is reasonable that a signed contract for the repair work exists, but this has no effect on the accrual.

QUESTION 620

In the current year Jensen had the following items:

Salary	\$50,000
Inheritance	25,000
Alimony from ex-spouse	12,000
Child support from ex-spouse	9,000
Capital loss on investment stock sale	(6,000)

What is Jensen's AGI for the current year?

A. \$44,000
B. \$59,000
C. \$62,000
D. \$84,000
Correct Answer: B
Section: Regulation
Explanation

Explanation/Reference:
Explanation:
Choice "b" is correct. The question asks for AGI, but all of the items in the list are items of potential gross income. There are no adjustments included in the list; therefore, in this case, AGI is the same as gross income. The calculation is as follows:

Salary	\$50,000
Inheritance	0 [not taxable]
Alimony from ex-spouse	12,000
Child support from ex-spouse	0 [not taxable]
Capital loss on investment stock sale	(3,000) [maximum deductible]
AGI	<u>\$59,000</u>

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

QUESTION 621 Which of the following is subject to the Uniform Capitalization Rules of Code Sec. 263A?

- A. Editorial costs incurred by a freelance writer.
B. Research and experimental expenditures.
C. Mine development and exploration costs.
D. Warehousing costs incurred by a manufacturing company with \$12 million in annual gross receipts.



Correct Answer: D
Section: Regulation
Explanation

Explanation/Reference:
Explanation:
Choice "d" is correct. Uniform capitalization rules apply to the following: (1) real or tangible personal property produced by the taxpayer for use in his or her trade or business; (2) real or tangible personal property produced by the taxpayer for sale to his or her customers; and (3) real or tangible personal property acquired by the taxpayer for resale, provided the taxpayer's annual average gross receipts for the preceding three years exceeds \$10,000,000. Warehousing costs incurred by a manufacturing company (making inventory for sale to its customers) are subject to the Uniform Capitalization Rules. Further, they are the only item on the list that is real or tangible personal property. In this case, the inventory is not acquired for resale (it is produced by the taxpayer for sale to his or her customers), so the fact that the annual sales are \$12,000,000 does not matter in this case. The sales could have been less than \$10,000,000 annually, and the Uniform Capitalization Rules would still have applied. Choices "a", "b", and "c" are incorrect, based on the above discussion.

QUESTION 622
Under the uniform capitalization rules applicable to taxpayers with property acquired for resale, which of the following costs should be capitalized with respect to inventory if no exceptions have been met?

	<u>Repackaging costs</u>	<u>Off-site storage costs</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

A. Option A

- B. Option B
- C. Option C
- D. Option D

Correct Answer: A
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Direct material, direct labor, and factory overhead (applicable indirect costs) are capitalized with respect to inventory under the uniform capitalization rules for property acquired for resale. Applicable indirect costs include depreciation and amortization, insurance, supervisory wages, utilities, spoilage and scrap, design expenses, repair and maintenance and rental of equipment and facilities (including offsite storage), some administrative costs, costs of bonus and other incentive plans, and indirect supplies and other materials (including repackaging costs). Choices "b", "c", and "d" are incorrect, per the above discussion.

QUESTION 623

Smith made a gift of property to Thompson. Smith's basis in the property was \$1,200. The fair market value at the time of the gift was \$1,400. Thompson sold the property for \$2,500. What was the amount of Thompson's gain on the disposition?

- A. \$0
- B. \$1,100C. \$1,300
- D. \$2,500

Correct Answer: C
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The general rule for the basis on gifted property is that the donee receives the property with a rollover cost basis (equal to the donor's basis). An exception exists where the fair market value of the property at the time of the gift is less than the donor's basis. That is not the case in this question; thus, the calculation of the gain on the disposition of the property is:

Amount realized	\$2,500
Basis	(1,200)
Gain recognized	<u>\$1,300</u>

Choice "a" is incorrect. This choice could be correct if the facts of the question met the exception whereby no gain or loss is recognized when a donee sells gifted property for an amount between the donor's basis and the fair market value at the date of the gift.

Choice "b" is incorrect. This choice uses the basis as the fair market value of the property. Fair market value of property at date of death is used as the basis for inherited property, not gifted property. Choice

"d" is incorrect. This choice assumes that Thompson's basis is zero. His basis is \$1,200 as indicated above.

QUESTION 624

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

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

Correct Answer: B
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

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

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

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

The general rule is the gain is recognized to the extent boot is received. As the transaction results in a loss to Leker (he received an asset worth \$10,000 plus \$3,000 cash less a \$20,000 tax basis equals \$7,000 loss) no gain is recognized and the \$3,000 received reduces his basis in the new asset.

Choice "a" is incorrect. Basis must be reduced by non-like-kind assets (boot) received.

Choice "c" is incorrect. For non-like-kind exchanges, the basis would be the FMV of the assets received (\$10,000 FMV plus \$3,000 Boot). However, because both assets have similar use, this is a like-kind exchange, which follows the rule above.

Choice "d" is incorrect. The basis of the old property is used to calculate the basis of the new property, less any boot received.

QUESTION 625

Capital assets include:

- A. A corporation's accounts receivable from the sale of its inventory.
- B. Seven-year MACRS property used in a corporation's trade or business.
- C. A manufacturing company's investment in U.S. Treasury bonds.
- D. A corporate real estate developer's unimproved land that is to be subdivided to build homes, which will be sold to customers.

Correct Answer: C

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Investment assets of a taxpayer that are not inventory are capital assets. The manufacturing company would have capital assets including an investment in U.S. Treasury bonds. Choice

"a" is incorrect. Accounts receivable generated from the sale of inventory are excluded from the statutory definition of capital assets.

Choice "b" is incorrect. Depreciable property used in a trade or business is excluded from the statutory definition of capital assets.

Choice "d" is incorrect. Land is usually a capital asset, but when it is effectively inventory, as when it is used by a developer to be subdivided, it is excluded from the statutory definition of capital assets.

QUESTION 626

Conner purchased 300 shares of Zinco stock for \$30,000 in 1980. On May 23, 1994, Conner sold all the stock to his daughter Alice for \$20,000, its then fair market value. Conner realized no other gain or loss during 1994. On July 26, 1994, Alice sold the 300 shares of Zinco for \$25,000.

What amount of the loss from the sale of Zinco stock can Conner deduct in 1994?

- A. \$0
- B. \$3,000
- C. \$5,000
- D. \$10,000

Correct Answer: A

Section: Regulation

Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Even though Conner has a realized loss of \$10,000 on this transaction he cannot deduct the loss since it was incurred in a transaction with his daughter, a related party.

Choice "b" is incorrect. \$3,000 is the limit on deductible net capital losses. However, Conner cannot deduct this loss, since it was incurred in a transaction with his daughter, a related party.

Choice "c" is incorrect. Conner's realized loss on the sale is \$10,000 (\$20,000 proceeds less \$30,000 basis). However, Conner cannot deduct this loss, since it was incurred in a transaction with his daughter, a related party.

Choice "d" is incorrect. \$10,000 is Conner's realized loss on the sale. However, Conner cannot deduct this loss, since it was incurred in a transaction with his daughter, a related party.

QUESTION 627

Conner purchased 300 shares of Zinco stock for \$30,000 in 1980. On May 23, 1994, Conner sold all the stock to his daughter Alice for \$20,000, its then fair market value. Conner realized no other gain or loss during 1994. On July 26, 1994, Alice sold the 300 shares of Zinco for \$25,000.

What was Alice's recognized gain or loss on her sale?

- A. \$0
- B. \$5,000 long-term gain.
- C. \$5,000 short-term loss.
- D. \$5,000 long-term loss.

Correct Answer: A
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. Alice has a realized gain of \$5,000 on the transaction: \$25,000 sales price less \$20,000 purchase price. However, she can reduce the gain, but not below zero, by the amount of loss her father could not deduct on the sale to her. Thus, Alice can reduce her gain by up to \$10,000, but not below zero. Here, the gain is \$5,000, so it is reduced to zero. Conner should have sold the stock in the open market so that he could deduct the entire loss. Alice could then have purchased the stock in the open market.

Choice "b" is incorrect. \$5,000 is Alice's realized long-term gain on the sale. However, she can reduce the gain, but not below zero, by the amount of loss her father could not deduct on the sale to her.

Choice "c" is incorrect. Alice has a realized gain of \$5,000 on the sale. However, since she is related to Conner, her holding period includes his holding period. Therefore, her realized gain is long-term. In addition, she can reduce the gain, but not below zero, by the amount of loss her father could not deduct on the sale to her.

Choice "d" is incorrect. Alice can reduce the gain by the amount of loss her father could not deduct on the sale to her. However, she cannot reduce the gain below zero.

QUESTION 628

Smith, an individual calendar-year taxpayer, purchased 100 shares of Core Co. common stock for \$15,000 on December 15, 1992, and an additional 100 shares for \$13,000 on December 30, 1992. On January 3, 1993, Smith sold the shares purchased on December 15, 1992, for \$13,000. What amount of loss from the sale of Core's stock is deductible on Smith's 1992 and 1993 income tax returns?

	<u>1992</u>	<u>1993</u>
A.	\$0	\$0
B.	\$0	\$2,000
C.	\$1,000	\$1,000
D.	\$2,000	\$0



- A. Option A
- B. Option B
- C. Option C
- D. Option D

Correct Answer: A
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. In 1992, no sale of stock occurred so there would be no loss. In 1993, there is a \$2,000 loss realized (\$15,000 basis less \$13,000 received), but it is not deductible because it is a wash sale. A wash sale occurs when a taxpayer sells stock at a loss and invests in substantially identical stock within 30 days before or after the sale. In this case, Smith reinvested in an additional 100 shares four days prior to selling 100 shares of the same stock at a loss. The \$2,000 disallowed loss would, however, increase the basis of the new shares by \$2,000.

Choice "b" is incorrect. The \$2,000 loss realized in 1993 is disallowed under the wash sale rules.

Choice "c" is incorrect. In 1992, there is no loss since no shares were sold. In 1993, the \$2,000 loss is disallowed under the wash sale rules.

Choice "d" is incorrect. In 1992, there is no possible loss since no shares were sold.

QUESTION 629

Greller owns 100 shares of Arden Corp., a publicly-traded company, which Greller purchased on January 1, 2001, for \$10,000. On January 1, 2003, Arden declared a 2-for-1 stock split when the fair market value (FMV) of the stock was \$120 per share. Immediately following the split, the FMV of Arden stock was \$62 per share. On February 1, 2003, Greller had his broker specifically sell the 100 shares of Arden stock received in the split when the FMV of the stock was \$65 per share. What is the basis of the 100 shares of Arden sold?

- A. \$5,000

- B. \$6,000 C. \$6,200
D. \$6,500

Correct Answer: A
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "a" is correct. The receipt of a nontaxable stock dividend will require the shareholder to spread the basis of his original share over both the original shares and the new shares received resulting in the same total basis, but a lower basis per share of stock held. Therefore, Greller total basis remains the same, \$10,000, but is now split between 200 shares (a 2-for-1 split and he originally owned 100 shares).

Therefore, his basis per share goes from \$100/share (\$10,000/100) to \$50/share (\$10,000/200).

Consequently, his basis in 100 share is $100 \times \$50 = \$5,000$.

Choices "b", "c", and "d" are incorrect per the above explanation.

QUESTION 630 Farr made a gift of stock to her child, Pat. At the date of gift, Farr's stock basis was \$10,000 and the stock's fair market value was \$15,000. No gift taxes were paid. What is Pat's basis in the stock for computing gain?

- A. \$0
B. \$5,000
C. \$10,000
D. \$15,000

Correct Answer: C
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. Property acquired as a gift generally retains the rollover cost basis as it had in the hands of the donor at the time of the gift. Basis is increased by any gift tax paid that is attributable to the net appreciation in the value of the gift. Since there were no gift taxes paid, Pat's basis for computing a gain is the rollover cost (basis), \$10,000. Choices "a", "b", and "d" are incorrect, per the explanation above.

QUESTION 631

Allen owns 100 shares of Prime Corp., a publicly-traded company, which Allen purchased on January 1, 2001, for \$10,000. On January 1, 2003, Prime declared a 2-for-1 stock split when the fair market value (FMV) of the stock was \$120 per share. Immediately following the split, the FMV of Prime stock was \$62 per share. On February 1, 2003, Allen had his broker specifically sell the 100 shares of Prime stock received in the split when the FMV of the stock was \$65 per share. What amount should Allen recognize as long-term capital gain income on his Form 1040, U.S. Individual Income Tax Return, for 2003?

- A. \$300
B. \$750
C. \$1,500
D. \$2,000

Correct Answer: C
Section: Regulation
Explanation

Explanation/Reference:

Explanation:

Choice "c" is correct. The receipt of a nontaxable stock dividend will require the shareholder to spread the basis of his original shares over both the original shares and the new shares received, resulting in the same total basis but a lower basis per share of stock held. Therefore, Allen's total basis remains the same, \$10,000, but is now split between 200 shares (a 2-for-1 split and he originally owned 100 shares). Therefore, his basis per share goes from \$100/share (\$10,000/100) to \$50/share (\$10,000/200).

Consequently, his basis in the 100 shares sold is $100 \times \$50 = \$5,000$. Calculate his gain as follows:

Amount realized (\$65 x 100)	\$6,500
Adjusted Basis (5,000 - calculated above)	<u>(5,000)</u>
Realized & recognized gain	\$1,500

Choices "a", "b", and "d" are incorrect.