

CPA PassMaster Questions–Financial 1
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Sources of GAAP

CPA-00001 Type1 M/C A-D Corr Ans: D PM#1 F 1-01

1. CPA-00001 FARE Nov 95 #1, Released 2006 Page 6

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.

CPA-00001 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

CPA-00004 Type1 M/C A-D Corr Ans: B PM#2 F 1-01

2. CPA-00004 FARE Nov 95 #2 Page 7

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.

CPA-00004 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. SFAC 2 para. 63

CPA-00006 Type1 M/C A-D Corr Ans: D PM#4 F 1-01

3. CPA-00006 FARE Nov 95 #5 Page 9

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.

CPA-00006 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.

CPA-00007 Type1 M/C A-D Corr Ans: D PM#5 F 1-01

4. CPA-00007 FARE May 95 #1 Page 8

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.

CPA-00007 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.

CPA-00011 Type1 M/C A-D Corr Ans: D PM#9 F 1-01

5. CPA-00011 FARE Nov 94 #2 Page 5

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.

CPA-00011 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.

CPA-00012 Type1 M/C A-D Corr Ans: D PM#10 F 1-01

6. CPA-00012 FARE Nov 94 #3 Page 11

What is the underlying concept that supports the immediate recognition of a contingent loss?

- a. Substance over form.
- b. Consistency.
- c. Matching.
- d. Conservatism.

CPA-00012 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

CPA-00013 Type1 M/C A-D Corr Ans: D PM#11 F 1-01

7. CPA-00013 FARE May 94 #1 Page 9

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.

CPA-00013 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

CPA-00014 Type1 M/C A-D Corr Ans: C PM#12 F 1-01

8. CPA-00014 FARE May 94 #2 Page 6

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.

CPA-00014 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.

CPA-00015 Type1 M/C A-D Corr Ans: C PM#13 F 1-01

9. CPA-00015 FARE May 94 #4 Page 6

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.

CPA-00015 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

CPA-00017 Type1 M/C A-D Corr Ans: B PM#15 F 1-01

10. CPA-00017 Th Nov 93 #6 Page 10

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.

CPA-00017 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.

CPA-00018 Type1 M/C A-D Corr Ans: A PM#16 F 1-01

11. CPA-00018PI Nov 93 #53 Page 11

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

CPA-00018 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)	<u>60,000</u>
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.

CPA-00022 Type1 M/C A-D Corr Ans: A PM#19 F 1-01

12. CPA-00022Th Nov 92 #2 Page 7

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.

CPA-00022 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.

CPA-05420 Type1 M/C A-D Corr Ans: D PM#30 F 1-01

13. CPA-05420 Released 2007 Page 4

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.

CPA-05420 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.

CPA-05434 Type1 M/C A-D Corr Ans: D PM#31 F 1-01

14. CPA-05434 Released 2007 Page 11

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.

CPA-05434 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.

CPA-05195 Type1 M/C A-D Corr Ans: D PM#31 F 1-01

15. CPA-05195 Released 2006 Page 6

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. AICPA Statements of Position.
- b. AICPA Industry and Audit Guides.
- c. FASB Statements of Financial Accounting Concepts.
- d. FASB Statements of Financial Accounting Standards.

CPA-05195 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.

CPA-05197 Type1 M/C A-D Corr Ans: B PM#32 F 1-01

16. CPA-05197 Released 2006 Page 6

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.

CPA-05197 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.

CPA-05234 Type1 M/C A-D Corr Ans: C PM#33 F 1-01

17. CPA-05234 Released 2006 Page 10

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.

CPA-05234 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.

CPA-05235 Type1 M/C A-D Corr Ans: C PM#34 F 1-01

18. CPA-05235 Released 2006 Page 3

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.

CPA-05235 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.

Reporting Net Income

CPA-00032 Type1 M/C A-D Corr Ans: D PM#3 F 1-02

19. CPA-00032 FARE R99 #2 Page 14

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.

CPA-00032 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.

CPA-05458 Type1 M/C A-D Corr Ans: A PM#3 F 1-02

20. CPA-05458 Released 2007 Page 15

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.

CPA-05458 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.

Income Statement

CPA-00035 Type1 M/C A-D Corr Ans: C PM#1 F 1-03

21. CPA-00035 FARE R01 #8 (Adapted) Page 20

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. \$40,000
- c. \$60,000
- d. \$90,000

CPA-00035 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.