Lambers CPA REVIEW

SAMPLE CHAPTER

Comprehensive Text, Questions and Solutions

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VOLUME 3	**Auditing (9 chapters)**
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The books are organized by chapter. Worksheets are also included for problems where required. Supporting the text are over 2,400 questions, problems and simulations from the most recent CPA exams, with explanatory solutions, all categorized by subject. This eliminates time-wasting searches through CPA exam booklets for questions and problems.

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Lambers
CPA REVIEW

Chapter Four
Consolidated Financial Statements

As a prelude to the study of consolidations, it is helpful to look at the terminology involved and the methods for accounting for investments in common stock.

Terminology

Normally for investments in which the investor does not have control, the investor is called the **investor** and the company invested in is called the **investee.** In situations in which the investor has control, the investor is called the **parent** and the company invested in is called the **subsidiary**.

Methods of Accounting for Investments in Common Stock

Percent of Common Stock Owned	*Level of Influence (assumed)*	*Valuation of Investment*	*Balance sheet Presentation*	*Income*
<20	Lacks significant	Cost/Fair Value	Investment	Dividends
20 - 50	Significant	Equity	Investment	% share
>50	Control	Either	Eliminate in consolidation	Eliminate in consolidation

Investments in Common Stock – Cost vs Equity Methods

As noted on the chart, the parent company may use either the cost or equity method for recording the investment in the subsidiary because the investment account is eliminated in consolidation and does not appear on the consolidated balance sheet. Dividend revenue recorded by the parent on the cost method or equity in subsidiary's income recorded by the parent is also eliminated by the consolidation process. Candidates should know the mechanics of both methods to understand the eliminating entries on the consolidation worksheet.

Cost Method

In using the chart, please note that it states that if the investor owns less than a 20% interest in the common stock of the investee, the cost method is used. This is a **guide**, not a rule. The rule is that the investor lacks **significant influence**. For example, ABC owns 15% of XYZ. ABC is the largest stockholder in XYZ and ABC's officers are a majority of the board-of-directors of XYZ. These two items give ABC significant influence in the operations of XYZ; therefore the investment would be recorded using the equity method instead of the cost method even though the ownership interest of 15% is less than the 20% guide indicated by the chart.

In reality, many of these investments in which the investor has no significant influence are reported at fair value, not cost. In Chapter 2, fair value is required if the investments in common stock of the investee meets the definition of a marketable equity security. In Chapter 7, under SFAS 159 the company has the option of reporting the investment at fair value. However, if the investment does not meet the definition of a marketable equity security or the fair value option is not used, the investment should be recorded at cost.

<u>Note</u>: The emphasis on the cost method in this chapter is because it is used in consolidations.

<u>Author's Note</u>: In the following examples, I will use the term **investee** because most of my illustrations will use investments below 50%. If the examples included investments above 50%, I would use the term **subsidiary.**

Journal Entries for the Cost Method

A.	JE To record the acquisition at cost		
	JE Investment investee (cost)	XX	
	Cash		XX
B.	To record the investors share of the investee's cash dividend		
	JE Cash	XX	
	Dividend Revenue		XX

<u>Note</u>: The receipt of a stock dividend from the investee does not change the total cost of the investment and is not dividend revenue. The stock dividend simply changes the average cost per share (basis) and is recorded using a (memo) entry.

Equity Basis

The chart indicates that an investment in the common stock of another company that gives the investor significant influence over the operations of the investee should be recorded using the equity basis. The theory of the equity method is that the investor should **reflect** on its books its share of changes occurring on the books of the investee.

For example: On January 2, Year 4. ABC purchased 40% of the outstanding stock of XYZ for $450,000. The carrying amount of XYZ's net assets (assets – liabilities) on the purchase date was $920,000. Fair values and carrying values were the same for all items except plant and inventory for which fair values exceeded their carrying amounts by $80,000 and $10,000 respectively. The plant had a 20 year life and all the inventory was sold in Year 4. During Year, XYZ reported net income of $150,000 and paid a cash dividend of $30,000.

Equity Method – Normal Journal Entries

A. To record the investment in the investee at cost

JE Investment in investee (cost)	450,000	
Cash		450,000

B. To record the investor's share of the investee's income (40% x $150,000 = $60,000).

JE Investment in investee	60,000	
Equity in NI of investee		60,000

Reflecting Theory: The investee's assets increased from the net income; therefore, ABC's asset , investment in investee, should reflect the increase. The investee's income statement increased because it had net income. Therefore, ABC's income statement account, Equity in Net Income of Investee, should reflect the increase for its 40% share of the investee's income.

C. To record the investor's share of the investee's dividends (40% x $30,000 = $12,000).

JE Cash	12,000	
Investment in investee		12,000

Reflecting Theory: The investee paid a cash dividend, so its assets decreased. Therefore, ABC's asset account, Investment in Investee, should reflect this decrease.

D. The fourth common entry using the equity method is the most complicated. It involves a situation in which the cost of the investment **includes** goodwill and undervalued or overvalued assets and/or liabilities.

In the ABC example, the investee's plant is undervalued by $80,000. ABC's share of the undervaluation is $32,000 (40% x $80,000). Remember the investee calculated depreciation expense included in its $150,000 net income based on the plants carrying value. Since ABC paid fair value for its 40% share of the plant, it should record additional depreciation on the $32,000. The additional depreciation should be $32,000 divided by the 20 year useful life for a total of $1,600 per year.

The same theory applies to the undervalued inventory. The investee included the book value of the cost of the inventory sold in its calculation of the $150,000 in net income. Since ABC paid fair value for its share of the additional cost of the inventory ($10,000 x 40% = $4,000), the $4,000 should be added to the cost of goods sold.

Therefore, Journal Entry "D" should include the combined total of the $1,600 additional depreciation plus the $4,000 additional cost of goods sold for a combined total of $5,600.

JE Equity in NI – Investee	5,600	
Investment in Investee		5,600

The final ledger accounts should appear as follows:

Investment in Investee

A) Cost	450,000	C) Share of dividends	12,000
B) Share of Net Income	60,000	D) Additional depreciation	1,600
		D) Additional cost of goods sold	4,000
December 31, Yr. 4 balance	492,400		

Equity in Net Income – Investee

D) Additional depreciation `	1,600	A) Share of net income	60,000
D) Additional cost of goods sold	4,000		
		Dec. 31, Yr. 4, balance	54,400

Goodwill

Occasionally the candidate will be required to calculate the amount of goodwill included in the cost of the investment in the investee. The calculation is as follows:

Price paid for investee			$450,000
vs			
ABC's share of the fair value of the investee's net assets			
Book value of net assets 40% x $920,000	=	$368,000	
Plus undervalued plant 40% x $80,000	=	32,000	
Plus undervalued inventory 40% x $10,000	=	4,000	
Total fair value of investee's net assets			(404,000)
Goodwill			$ 46,000

Note: Candidates may be confused because there is no mention of testing goodwill for impairment. SFAS 142 states that goodwill implicit in equity method investments will not be tested for impairment. However like all assets, equity method investments (not just the goodwill portion) will be tested for permanent declines in value.

Equity Method when the Investee has Preferred Stock

If the investee (XYZ) had a $20,000 preferred dividend, ABC would calculate its share of XYZ's income based on the income available to common shareholders. (Similar to the calculation of Earnings per Share.) The income available to common shareholders would be investee's net income of $150,000 less the preferred income of $20,000 for a net of $l30,000. Therefore, ABC's share of XYZ's net income would be 40% x $130,000 = $52,000.

Special Problems – Cost vs Equity

Converting from equity method to cost method: The conversion from equity to cost is very simple. For example, ABC purchased 40% interest in XYZ in Year 3 for $500,000 and recorded the investment on the equity basis. When the balance in the investment account on July 1, **Year 4** was $540,000 and the balance in the equity in net income of the investee was $60,000, ABC sold a portion of its investment ($300,000) for $320,000 which reduced its interest in XYZ to 15%. XYZ's income for the last 6 months of Year 4 was $100,000. On December 1, Year 4, XYZ paid dividends of $50,000. The ledger (T-accounts) are as follows:

Investment in Investee – XYZ

July 1, Year 4 balance	540,000	July 1, Year 4 sold	300,000
Dec. 31, Year 4 balance	240,000		

Equity in Net Income – Investee XYZ

		July 1, Year 4 share of income	60,000

Dividend Revenue

		Dec. 1, Year 4 share of dividends	7,500

Gain on Sale of Investment

		July 1, Year 4 JE	20,000

The Journal Entry for the sale of the investment is as follows:

July 1, Year 4 JE Cash	320,000	
Investment in Investee – XYZ		300,000
Gain on Sale of Investment		20,000

After the July 1, Year 4 Journal Entry, ABC's investment was reduced to 15%. At that point ABC **automatically** switched to the cost basis. So on December 1, Year 4 it would record its share of XYZ's cash dividend (15% x $50,000 = $7,500) as a debit to cash and a credit to dividend revenue.

To summarize, ABC would report on its balance sheet a long-term investment in XYZ of $240,000 and report on the income statement in the equity in net income of the investee account $60,000 for the first 6 months of Year 4 and dividend revenue of $7,500 for the last 6 months of the year and gain on sale of investment of $20,000.

Converting Cost to Equity Basis

The conversion from cost to equity is more complicated. The conversion requires that ABC record a prior period adjustment to convertt the prior year's cost basis to equity basis. For example: If ABC had owned 10% of XYZ in Year 3 (which would be recorded on the cost basis) but purchased an additional 25% in Year 4, the investment would now be on the equity basis. The accounting on the date of purchase would be to convert the Year 3 investment to equity basis. The conversion would be to record a prior years adjustment to adjust the investment and the January 1, Year 4 retained earnings for XYZ's 10% change in retained earnings in Year 3. Remember, in Year 3 ABC recorded 10% of XYZ's dividends. The Journal Entry in Year 4 would be as follows:

Chapter Four contains additional text that has been omitted from this sample chapter.

Chapter Four
Consolidated Financial Statements Questions

COST METHOD

1. Day Co. received dividends from its common stock investments during the year ended December 31, Year 2, as follows:

- A stock dividend of 400 shares from Parr Corp. on July 25, Year 2, when the market price of Parr's shares was $20 per share. Day owns less than 1% of Parr's common stock.
- A cash dividend of $15,000 from Lark Corp. in which Day owns a 25% interest. A majority of Lark's directors are also directors of Day.

What amount of dividend revenue should Day report in its Year 2 income statement?
a. $23,000
b. $15,000
c. $8,000
d. $0

EQUITY METHOD

2. On July 1, Year 3, Denver Corp. purchased 3,000 shares of Eagle Co.'s 10,000 outstanding shares of common stock for $20 per share. On December 15, Year 3, Eagle paid $40,000 in dividends to its common stockholders. Eagle's net income for the year ended December 31, Year 3, was $120,000, earned evenly throughout the year. In its Year 3 income statement, what amount of income from this investment should Denver report?
a. $36,000
b. $18,000
c. $12,000
d. $6,000

3. On January 2, Year 2, Well Co. purchased 10% of Rea, Inc.'s outstanding common shares for $400,000. Well is the largest single shareholder in Rea, and Well's officers are a majority on Rea's board of directors. Rea reported net income of $500,000 for Year 2, and paid dividends of $150,000. In its December 31, Year 2, balance sheet, what amount should Well report as investment in Rea?
a. $450,000
b. $435,000
c. $400,000
d. $385,000

4. On January 1, Year 4, Barton Corporation acquired as a long-term investment for $500,000, a 30% common stock interest in Buffer Company. On that date, Buffer had net assets with a book value and current market value of $1,600,000. During Year 4 Buffer reported net income of $180,000 and declared and paid cash dividends of $40,000. What is the amount of income that Barton should report from this investment for Year 4?
a. $12,000.
b. $42,000.
c. $53,500.
d. $54,000.

5. Sage, Inc., bought 40% of Adams Corp.'s outstanding common stock on January 2, Year 2, for $400,000. The carrying amount of Adams' net assets at the purchase date totaled $900,000. Fair values and carrying amounts were the same for all items except for plant and inventory, for which fair values exceeded their carrying amounts by $90,000 and $10,000, respectively. The plant has an 18-year life. All inventory was sold during Year 2. During Year 2, Adams reported net income of $120,000 and paid a $20,000 cash dividend. What amount should Sage report in its income statement from its investment in Adams for the year ended December 31, Year 2?
a. $48,000
b. $42,000
c. $36,000
d. $32,000

6. Park Co. uses the equity method to account for its January 1, Year 4, purchase of Tun Inc.'s common stock. On January 1, Year 4, the fair values of Tun's FIFO inventory and land exceeded their carrying amounts. How do these excesses of fair values over carrying amounts affect Park's reported equity in Tun's Year 4 earnings?

	Inventory excess	*Land excess*
a.	Decrease	Decrease
b.	Decrease	No effect
c.	Increase	Increase
d.	Increase	No effect

Items 7 through 9 are based on the following:

Grant, Inc. acquired 30% of South Co.'s voting stock for $200,000 on January 2, Year 2. Grant's 30% interest in South gave Grant the ability to exercise significant influence over South's operating and financial policies. During Year 2, South earned $80,000 and paid dividends of $50,000. South reported earnings of $100,000 for the six months ended June 30, Year 3, and $200,000 for the year ended December 31, Year 3. On July 1, Year 3, Grant sold half of its stock in South for $150,000 cash. South paid dividends of $60,000 on October 1, Year 3.

7. Before income taxes, what amount should Grant include in its Year 2 income statement as a result of the investment?

a. $15,000
b. $24,000
c. $50,000
d. $80,000

8. In Grant's December 31, Year 2, balance sheet, what should be the carrying amount of this investment?

a. $200,000
b. $209,000
c. $224,000
d. $230,000

9. In its Year 3 income statement, what amount should Grant report as gain from the sale of half of its investment?

a. $24,500
b. $30,500
c. $35,000
d. $45,500

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10. Moss Corp. owns 20% of Dubro Corp.'s preferred stock and 80% of its common stock. Dubro's stock outstanding at December 31, Year 2, is as follows:

10% cumulative preferred stock	$100,000
Common stock	700,000

Dubro reported net income of $60,000 for the year ended December 31, Year 2. What amount should Moss record as equity in earnings of Dubro for the year ended December 31, Year 2?

a. $42,000
b. $48,000
c. $48,400
d. $50,000

11. On January 1, Year 2, Mega Corp. acquired 10% of the outstanding voting stock of Penny, Inc. On January 2, Year 3, Mega gained the ability to exercise significant influence over financial and operating control of Penny by acquiring an additional 20% of Penny's outstanding stock. The two purchases were made at prices proportionate to the value assigned to Penny's net assets, which equaled their carrying amounts. For the years ended December 31, Year 2 and Year 3, Penny reported the following:

	Year 2	*Year 3*
Dividends paid	$200,000	$300,000
Net income	600,000	650,000

In Year 3, what amounts should Mega report as current year investment income and as an adjustment, before income taxes, to Year 2 investment income?

	Year 3 investment income	*Adjustment to Year 2 investment income*
a.	$195,000	$160,000
b.	$195,000	$100,000
c.	$195,000	$40,000
d.	$105,000	$40,000

12. When the equity method is used to account for investments in common stock, which of the following affect(s) the investor's reported investment income?

	A change in market value of investee's common stock	*Cash dividends from investee*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

CONSOLIDATION—GOODWILL

13. Penn Corp. paid $300,000 for the outstanding common stock of Star Co. At that time, Star had the following condensed balance sheet:

	Carrying amounts
Current assets	$ 40,000
Plant and equipment, net	380,000
Liabilities	200,000
Stockholders' equity	220,000

The fair value of the plant and equipment was $60,000 more than its recorded carrying amount. The fair values and carrying amounts were equal for all other assets and liabilities.

In addition, Penn paid $20,000 in accounting, attorney and investment banker fees directly associated with the acquisition.

What amount of goodwill, related to Star's acquisition, should Penn report in its consolidated balance sheet?

a. $20,000
b. $40,000
c. $60,000
d. $80,000

14. On April 1, Year 4, Dart Co. paid $620,000 for all the issued and outstanding common stock of Wall Corp. in a transaction properly accounted for as a purchase. The recorded assets and liabilities of Wall Corp. on April 1, Year 4, follow:

Cash	$ 60,000
Inventory	180,000
Property and equipment (net of accumulated depreciation of $220,000)	320,000
Goodwill (net of accumulated amortization of $50,000)	100,000
Liabilities	(120,000)
Net assets	$540,000

On April 1, Year 4, Wall's inventory had a fair value of $150,000, and the property and equipment (net) had a fair value of $380,000. What is the amount of goodwill resulting from the business combination?

a. $150,000
b. $120,000
c. $50,000
d. $20,000

15. On June 30, Year 4, Needle Corporation purchased for cash at $10 per share all 100,000 shares of the outstanding common stock of Thread Company. The total appraised value of identifiable assets less liabilities of Thread was $1,400,000 at June 30, Year 4, including the appraised value of Thread's property, plant, and equipment (its only noncurrent asset) of $250,000. The consolidated financial statement of Needle Corporation and its wholly owned subsidiary at June 30, Year 4, should reflect

a. An extraordinary gain of $150,000.
b. An ordinary gain of $400,000.
c. An extraordinary gain of $400,000.
d. Goodwill of $400,000.

16. In a business combination accounted for as a purchase, the appraisal values of the identifiable assets acquired exceeds the acquisition price. The excess appraisal value should be reported as a

a. Deferred credit.
b. Reduction of the values assigned to current assets and a deferred credit for any unallocated portion.
c. Gain on bargain purchase.
d. Pro rata reduction of the values assigned to current and noncurrent assets.

CONSOLIDATION THEORY

17. Which of the following is the **best theoretical** justification for consolidated financial statements?

a. In form the companies are one entity; in substance they are separate.
b. In form the companies are separate; in substance they are one entity.
c. In form and substance the companies are one entity.
d. In form and substance the companies are separate.

18. When a parent-subsidiary relationship exists, consolidated financial statements are prepared in recognition of the accounting concept of

a. Reliability.
b. Materiality.
c. Legal entity.
d. Economic entity.

19. Company X acquired for cash all of the outstanding common stock of Company Y. How should Company X determine in general the amounts to be reported for the inventories and long-term debt acquired from Company Y?

	Inventories	*Long-term debt*
a.	Fair value	Fair value
b.	Fair value	Recorded value
c.	Recorded value	Fair value
d.	Recorded value	Recorded value

20. Company J acquired all of the outstanding common stock of Company K in exchange for cash. The acquisition price exceeds the fair value of net assets acquired. How should Company J determine the amounts to be reported for the plant and equipment and long-term debt acquired from Company K?

Chapter Four contains additional questions, problems and simulations that have been omitted from this sample chapter.

Chapter Four
Solutions to Consolidated Financial Statements Questions

1. (d) $0 dividend revenue. Receipt of a stock dividend (usually) does not constitute dividend income to the investor, rather it reduces the cost basis per share of the investment. Therefore, the 400 shares received as a stock dividend from Parr Corp. would not be included in dividend income.

2. (b) Denver Corp. acquired 30% of Eagle Company's outstanding common stock. With no evidence to the contrary, an investment of 20% or more is assumed to give significant influence, and would be accounted for using the equity method. Under the equity method the investor recognizes in income its share of the investee's net income or loss subsequent to the date of acquisition.
Investment income = $120,000 × 30% × 1/2 year = $18,000

3. (b) $435,000. The equity method of accounting for investments in common stock should be used if the investor has significant influence over the operating and financial policies of the investee. Well Company's significant influence is demonstrated in its officers being a majority of the investees' board of directors.

Original cost of investment		$400,000
Add: Share of income subsequent to acquisition		
	10% x $500,000	50,000
Less: Dividend of investee		
	10% x $150,000	(15,000)
		$435,000

4. (c) $54,000.

Cost of investment	$500,000
FV of net assets purchased—30% × $1,600,000	480,000
Goodwill	$ 20,000
Buffer's net income	$180,000
Barton's share (30% × $180,000)	$54,000

Note: Candidates may be confused because there is no mention of testing goodwill for impairment. SFAS 142 states that goodwill implicit in equity method investments will not be tested for impairment. However, like all assets, equity method investments (not just the goodwill portion) will be tested for permanent declines in value.

5. (b) $42,000 income from investment in Adams. Under the equity method the investor recognizes in income its share of the investee's net income or loss subsequent to the date of acquisition. Furthermore, the investor should reflect adjustments which would be made in consolidation, based on the investor's percentage ownership, if such adjustments (eliminations) can be recorded between investment income and the investment account.

Sage's share of Adams' net income (40% × $120,000)	$48,000
Less: Amortization of depreciable assets fair value in excess of book value $90,000 ÷ 18 yrs. × 40%	(2,000)
Fair value of inventory in excess of book value charged to cost of goods sold $10,000 × 40%	(4,000)
Income from investment in Adams	$42,000

There was no goodwill resulting from the investment.

Cost of investment		$400,000
Fair value of net assets acquired		
Book value	$ 900,000	
Fair value in excess of book value		
Plant	90,000	
Inventory	10,000	
Fair value of net assets	1,000,000	
% acquired	× 40%	400,000
Goodwill		—0—

6. (b) Under the equity method, the investor should reflect adjustments which would be made in consolidation, based on the investor's percentage ownership, if such adjustment (eliminations) can be recorded between investment income and the investment account. The fair value of the FIFO inventory in excess of the carrying value would reduce net income of the investee, therefore, the investor would charge investment income and credit the investment account to reflect the decrease in income. The fair value of the land in excess of its carrying value would not affect income as it is not a depreciable asset. No adjustment would be made relative to the land.

7. (b) $24,000 Investment income. As Grant's investment gives it the ability to exercise significant influence over South's operating and financial policies, the equity method would be used to account for the investment. Grant's equity in South's income is $24,000 (30% x $80,000 income).

8. (b) $209,000 Investment carrying value at 12/31/YR2

Original cost	$200,000
Add: Equity in South's income (#7)	24,000
Less: Dividends received (30% x $50,000)	(15,000)
Carrying value 12/31/YR2	$209,000

9. (b) $30,500 Gain on sale of investment.

Carrying value 12/31/YR2 (#8)	$209,000
Add: Equity in South's income 1/1 to 7/1/YR3	
30% x $100,000	30,000
Carrying value 7/1/YR3	$239,000
1/2 investment carrying value	$119,500
Sales proceeds on 1/2 of investment	150,000
Gain on sale of investment	$ 30,500

Note: As investment is now reduced to 15%, it will be accounted for by the cost method (assuming no significant influence).

10. (a) $42,000. When an investee has cumulative preferred stock outstanding, an investor should compute its share of investee's earnings after deducting the preferred dividends, whether or not such dividends are declared.

Equity in earnings applicable to common stock		
Net income		$60,000
Less: Preferred dividends ($100,000 par x 10%)		10,000
Net income applicable to common stock		$50,000
Moss' percentage ownership (common)		x 80%
Moss' equity in earning applicable to common stock		$40,000
Equity on earnings applicable to Preferred Stock		
Preferred dividend	$10,000	
Moss' percentage ownership (preferred)	x 20%	2,000
Moss' equity in Dubro's earnings		$42,000

Chapter Four contains additional answers that have been omitted from this sample chapter.

Chapter One
Filing Status and Exemptions, Filing Requirements and Penalties

OVERVIEW TO INDIVIDUAL TAXATION

The taxation of individuals starts with a very basic formula:

Gross income
<u>Minus deductions</u>
Equals taxable income

In our first four chapters, you will examine what makes up the gross income and allowable deductions of individuals. The CPA examination will test you on various components of the income and deductions, as well as various methods of determining the tax and a host of tax credits.

This very basic formula will expand as you are introduced to various classifications of deductions. You will be exposed to limitations on certain deductions based upon thresholds or ceilings, as well as phaseouts for exemptions and special rates. To be sure, there is a lot of complexity. But in the end, it comes back to income minus deductions equals taxable income.

In broad terms, gross income includes all items of income, unless specifically excluded by the Internal Revenue Code. By contrast, nothing is deductible unless specifically allowed by the Code. As a result, you will find that Chapter 2, which deals with inclusions and exclusions of income, is relatively short in comparison to the size of Chapters 3 and 4, which deal with the various deductions.

To help you better understand Chapter 1 and what lies ahead, follow through this simple example.

Example 1: K is single, aged 63 and earned $12,000 working part-time. In addition, K earned interest income of $1,500 and dividend income of $1,000. K also received social security benefits this year of $2,000. K does not itemize her deductions.

K's taxable income for 2015 is computed as follows:

Salary income	$ 12,000
Interest income	1,500
Dividend income	1,000
Total gross income	14,500
Less: Standard deduction	(6,300)
Less: Personal exemption	(4,000)
Taxable income	$ 4,200

K's **gross income**, as more fully explained in Chapter 2, is comprised of salary, interest and dividend income. Social security benefits are not included in gross income unless they pass a threshold test as you will learn about in Chapter 2. Since K does not "itemize" her deductions, she is allowed a standard amount of deductions. You will learn more about itemized deductions in Chapter 4. For 2015, the **standard deduction** is $6,300 for single taxpayers. The amount of the standard deduction is based upon the filing status of the taxpayer. This is addressed in this chapter. The other deduction is the **personal exemption** and for 2015 it is $4,000. This, too, is discussed in this chapter.

This is the most comprehensive problem you need to understand in this chapter. Now let's look at the taxpayer's Filing Status and Exemptions in detail.

FILING STATUS

There are five filing statuses available to individual taxpayers. Since filing status determines your tax rate structure (See Chapter 5 for the complete rate structure) and the amount of your standard deduction, choosing the proper filing status is important in minimizing your taxes.

1. Single, or unmarried. If a taxpayer is unmarried on the last day of the tax year, or is separated by a decree of divorce or separate maintenance, that taxpayer is considered single. Assuming the taxpayer does not qualify for a more favorable filing status such as head of household, or qualifying widower, an unmarried taxpayer must file as a single taxpayer.

2. Married Filing Jointly. To qualify for this status, the taxpayer must be married as of the last day of the year. In the event of the death of the spouse during the year, the spouse need only be alive on the first day of that year in order to qualify as being married for the entire year. Taxpayers are prohibited from filing jointly if their spouse is a non-resident alien or they have different tax year-ends from one another. Couples filing jointly may use different accounting methods in filing their joint return. A further discussion of these accounting methods can be found in Chapter 5. For federal tax purposes, a marriage means only a legal union between a man and a woman as husband and wife unless state law allows for the marriage of same sex partners to be recognized in that state.

3. Married Filing Separately. Married taxpayers may elect to file separate returns for a number of reasons. Issues of privacy, disclosure of tax returns by public officials, and possible tax planning in the shifting of deductions are some reasons as to why this status is available. In filing a separate return, both taxpayers must agree to either claiming (splitting) the standard deduction, or itemizing their deductions. One cannot itemize and the other claim the standard deduction.

4. Head of Household. This status is available to an unmarried taxpayer who:

1. maintains a household and provides for more than 50% of the year the cost for
2. their **qualifying child** or **any other relative who is a dependent** as a member of his household. (Discussed later in this chapter)

In determining the cost of maintaining the household, you would include the cost of the food consumed in the home, as well as mortgage interest and real estate taxes (or rent), utilities and repairs. A special exception to this rule is that the taxpayer's parents are not required to live with the taxpayer. The taxpayer must maintain more than 50% of the parent's home, or more than 50% of their nursing home costs, in order to qualify. The parent must also qualify as the taxpayer's dependent.

5. Qualifying widow(er) with dependent child. This is also referred to as surviving spouse. If your spouse dies during the taxable year, you are entitled to file married, filing jointly for that year. In the two years following the death of your spouse, the taxpayer may elect qualifying widow(er) if:

1. The taxpayer has not remarried, and
2. maintains more than 50% of the cost of the home where,
3. the dependent child resides for the entire year.

STANDARD DEDUCTION

Once the determination of the appropriate filing status has been made, the amount of the standard deductions are as follows:

	2015
Single, or unmarried	$6,300
Married, filing jointly	12,600
Married, filing separately	6,300
Head of household	9,250
Qualifying widow(er)	12,600

You do not need to memorize these amounts. On past exams the candidate has been provided with these amounts as needed. You should, however, understand how amounts change in relation to one another. For example, both single and married filing separately are exactly one-half of the married filing jointly. Head of household is between single and married. This relationship is important should the examiners ask you to determine what the most beneficial filing status is.

ADDITIONAL STANDARD DEDUCTION

There is an additional standard deduction available to the taxpayer who is 65 years or older, or blind. The additional standard deduction is added to the basic standard deduction in the determination of taxable income. The amounts are as follows:

	2015
Single or head of household	$ 1,550
Married or surviving spouse	1,250

Example 2: T is single, 67 and blind. For 2015, she is entitled to a **total** standard deduction of:

Regular standard deduction	$ 6,300
Additional standard deductions:	
65 or over	1,550
Blind	1,550
Total standard deduction	$ 9,400

Chapter One contains additional text that has been omitted from this sample chapter.

Chapter One — Questions
Filing Status and Exemptions, Filing Requirements and Penalties

Filing Status

1. John and Mary Arnold are a childless, married couple who lived apart (alone in homes maintained by each) the entire year. On December 31, 2015, they were legally separated under a decree of separate maintenance. Which of the following is the only filing status choice available to them when filing for 2015?
a. Single.
b. Head of household.
c. Married filing separate return.
d. Married filing joint return.

2. A husband and wife can file a joint return even if
a. The spouses have different tax years, provided that both spouses are alive at the end of the year.
b. The spouses have different accounting methods.
c. Either spouse was a nonresident alien at any time during the tax year, provided that at least one spouse makes the proper election.
d. They were divorced before the end of the tax year.

3. During 2015 Robert Moore, who is 50 years old and unmarried, maintained his home in which he and his widower father, age 75, resided. His father had $5,000 interest income from a savings account and also received $2,400 from social security during 2015. Robert provided 60% of his father's total support for 2015. What is Robert's filing status for 2015, and how many exemptions should he claim on his tax return?
a. Head of household and 2 exemptions.
b. Single and 2 exemptions.
c. Head of household and 1 exemption.
d. Single and 1 exemption.

4. Murray Richman, who is 60 years old and unmarried, was the sole support of his aged mother. His mother was a resident of a home for the aged for the entire year and had no income. What is Richman's filing status, and how many exemptions should he claim on his tax return?
a. Head of household and 2 exemptions.
b. Single and 2 exemptions.
c. Head of household and 1 exemption.
d. Single and 1 exemption.

5. Emil Gow's wife died in 2013. Emil did not remarry, and he continued to maintain a home for himself and his dependent infant child during 2014 and 2015, providing full support for himself and his child during these years. For 2015, Emil's filing status is
a. Single.
b. Head of household.
c. Qualifying widower with dependent child.
d. Married filing joint return.

6. Which of the following is(are) among the requirements to enable a taxpayer to be classified as a "qualifying widow(er)" ?

I. A dependent has lived with the taxpayer for six months.
II. The taxpayer has maintained the cost of the principal residence for six months.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

R06

7. 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.

R08

8. A couple filed a joint return in prior tax years. During the current tax year, one spouse died. The couple has no dependent children. What is the filing status available to the surviving spouse for the first subsequent tax year?
a. Surviving spouse.
b. Married filing separately.
c. Single.
d. Head of household.

9. A taxpayer's spouse dies in August of the current year. Which of the following is the taxpayer's filing status for the current year?
a. Single.
b. Qualified widower.
c. Head of household.
d. Married filing jointly.

Exemptions

10. Mark Erickson, age 46, filed a joint return for 2015 with his wife Helen, age 24. Their son John was born on December 16, 2015. Mark provided 60% of the support for his 72-year-old widowed mother until April 10, 2015, when she died. His mother's only income was from social security benefits totaling $2,200 during 2015. How many exemptions should the Erickson's claim on their 2015 tax return?
a. 2.
b. 3.
c. 4.
d. 5.

11. Jim and Kay Ross contributed to the support of their two children, Dale and Kim, and Jim's widowed parent, Grant. For 2015, Dale, a 19-year old full-time college student, earned $4,500 as a baby-sitter. Kim, a 23-year old bank teller, earned $12,000. Grant received $5,000 in dividend income and $4,000 in nontaxable social security benefits. Grant, Dale, and Kim are U.S. citizens and were over one-half supported by Jim and Kay. How many exemptions can Jim and Kay claim on their 2015 joint income tax return?
a. Two.
b. Three.
c. Four.
d. Five.

12. Mr. and Mrs. Brook, both age 62, filed a joint return for this taxable year. They provided all the support for their son who is 19, legally blind, and who had no income. Their daughter, age 21 and a full-time student at a university, had $4,200 of gross income and is self supporting. How many exemptions should Mr. and Mrs. Brook have claimed on their joint income tax return?
a. 5.
b. 4.
c. 3.
d. 2.

13. Albert and Lois Stoner, age 66 and 64, respectively, filed a joint tax return for this taxable year. They provided all of the support for their blind 19-year-old son, who has no gross income. Their 23-year-old daughter, a full-time student until her graduation on June 14, earned $2,000, which was 40% of her total support during the year. Her parents provided the remaining support. The Stoner's also provided the total support of Lois' father, who is a citizen and life-long resident of Peru. How many exemptions can the Stoner's claim on their income tax return?
a. 4.
b. 5.
c. 6.
d. 7.

14. During the year, Sam Dunn provided more than half the support for his wife, his father's brother, and his cousin. Sam's wife was the only relative who was a member of Sam's household. None of the relatives had any income, nor did any of them file an individual or a joint return. All of these relatives are U.S. citizens. Which of these relatives should be claimed as a dependent or dependents on Sam's return?
a. Only his wife.
b. Only his father's brother.
c. Only his cousin.
d. His wife, his father's brother, and his cousin.

15. Mary Dunn provided 20% of her own support; the remaining 80% was provided by her three sons as follows:

Bill	15%
Jon	25%
Tom	40%
	80%

Assume that a multiple support agreement exists and that the brothers will sign multiple support declarations as required. Which of the brothers is eligible to claim the mother as a dependent?
a. None of the brothers.
b. Tom only.
c. Jon or Tom only.
d. Bill, Jon or Tom.

Chapter One contains additional questions, problems and simulations that have been omitted from this sample chapter.

Chapter One — Answers
Filing Status and Exemptions, Filing Requirements and Penalties

1. (a) Single. A taxpayer's filing status is determined on the last day of the taxable year. On December 31, 2015, John and Mary were legally separated under a decree of separate maintenance and therefore, not married. Since they did not have a child, they would not qualify as head of household. Single is the only status available.

2. (b) Husbands and wives cannot file a joint return if they have different tax years, if one is a non-resident alien, or they were divorced as of the end of the year. They are not, however, required to use the same accounting methods.

3. (d) Single and 1 exemption. Robert does not qualify for head of household because his father does not qualify as his dependent. His father does not qualify as his dependent because as a qualified relative he fails the gross income test. The gross income of $5,000 from the interest income exceeds the exemption amount of $4,000 for 2015. Social security is not a component of gross income at this income level.

4. (a) Murray qualifies as head of household because he is (1) unmarried; (2) maintains support for his mother at a home for the aged (parents do not have to reside in the taxpayer's home); and (3) may claim his mother as his dependent.

5. (c) Qualifying widower with dependent child. This is sometimes referred to as surviving spouse. In the year of death, Emil would have filed married, filing jointly. However, for the two years after that, Emil qualifies for this status provided he (1) has not remarried and (2) maintains a home for himself and a dependent child.

6. (d) Neither I nor II. In order to qualify as qualifying widower (or surviving spouse), your **child** must qualify as your dependent and must reside with you for the **entire year**. Also, you must maintain more than 50% of the cost of your household for the **entire year**.

7. (a) The married filing jointly status is only allowed for taxpayers who are still married as of the last day of the year. Since answer c indicates that the taxpayer is divorced, that eliminates that response. However, taxpayers who are still married but live under a legal separation agreement are not considered married for tax purposes. Therefore, answers b and d are not viable either.

8. (c) Single. The taxpayer is unmarried for the entire year, and since the spouse does not have any dependent children, the spouse would not qualify as head of household or surviving spouse.

9. (d) Married filing jointly. A taxpayer is considered married for the year in which the spouse passes away.

10. (c) 4. Mark is entitled to two personal exemptions and two dependency exemptions. Their new son qualifies because he was born before the end of the year. His mother qualifies because he met the support test until she died and she did not violate the gross income test. Social security benefits are not considered gross income at this income level.

11. (b) 3. Jim and Kay may claim two personal exemptions for themselves and one dependency exemption for Dale. The children, Dale and Kim, and the father, Grant, meet the support and relationship. Dale is not **under** 19, but he is under 24 and is a full-time student. Therefore he is a qualified child and there is no gross income test. Kim is also under 24, but is not a full-time student. Therefore, Kim is not a qualified child but a qualified relative and needs to pass the gross income test. Her $12,000 in babysitting income is not less than the 2015 exemption amount of $4,000 and she does not qualify. Grant is the parent and therefore is a qualifying relative. He has gross income of $5,000 and does not qualify under the gross income test either.

12. (c) 3. The Brooks are allowed two personal exemptions and one dependency exemption for their son. Their daughter does not qualify because of the support test. There is no exception to the support test (even though she is a full-time student).

13. (a) 4. The Stoners are allowed two personal exemptions and two dependency exemptions for their children. Stoner's father does not qualify because he fails the citizenship test. Note there are no extra exemptions because the taxpayer, or dependents are 65 and over, or blind.

14. (b) Father's brother. This question specifically asks about the dependency exemption, not the personal (which the wife would qualify as). Sam's uncle qualifies because he satisfies the relationship test and therefore does not need to be a member of the household. Sam's cousin does not qualify as a dependent because he is not a relative and as a result must be a member of the household for the entire year, which he was not.

15. (d) Bill, Jon or Tom. Classic multiple support problem. All three sons are qualified to claim Mom as their dependent but no one person contributes more than 50%. Since each son contributed more than 10% of her support, each is eligible to claim her.

Chapter One contains additional answers that have been omitted from this sample chapter.

Excerpt from Volume 3—Auditing

Chapter One
Introduction, General and Field Standards

INTRODUCTION

OBJECTIVE OF THE ORDINARY EXAMINATION OF FINANCIAL STATEMENTS

To express an opinion on reliability and fairness of management prepared financial statements by means of the auditor's report.

STANDARD SHORT-FORM AUDITOR'S REPORT—UNQUALIFIED

(Note: Audit reports are covered in detail in Chapter 3. Discussion here is for quick reference purposes only.)

The form of the standard report on financial statements covering a single year is as follows:

Independent Auditor's Report

Board of Directors
X Corporation

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. *These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.*

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of (at) December 31, 20XX, and the results of its operations and its cash flows for the year then ended *in conformity with accounting principles generally accepted in the United States of America.*

(Date of completion of audit)
(Firm Name and Signature) *(Italics added for emphasis)*

Briefly, the auditors standard report may be modified and take one of the following forms:

Qualified Report—Usually issued when the auditor takes exception to a material item or items in the financial statements because of departures from GAAP. A qualified opinion may also be issued when the auditor's examination is restricted with respect to an item on the financial statements. This type of report communicates to the reader of the financial statements that management's financial reports are fairly presented "except for" a departure from GAAP, which is material enough to mention but not pervasive enough to render the financial statements misleading when taken as a whole.

Adverse Report—Issued when the auditor feels that the departures from GAAP are serious enough to render the statements misleading. In this case, the CPA was able to apply auditing procedures, but discovered material and pervasive departures from GAAP that the client refused to correct. Thus, the dividing line between "except for" (qualified) opinion and an adverse opinion is one of materiality and pervasiveness of the departure from GAAP.

Disclaimer Report—Issued when the auditor's examination was incomplete (scope restricted because of nature of examination or other audit restrictions) to the point where he was unable to express an opinion on the financial statements or where the uncertainties have a pervasive and material effect on the financial statements. Thus, a disclaimer can result from inadequate auditing procedures or material uncertainties.

A complete discussion of the auditor's reporting function is in Chapter 3.

DISTINCTION BETWEEN RESPONSIBILITIES OF AUDITOR AND MANAGEMENT

1. Fairness of the representations contained in financial statements is part of ***management's responsibility***.
2. ***Management*** is responsible for development of adequate controls, safeguarding of assets, sound accounting policies that will produce proper statements (i.e., internal control).
3. ***Auditor's responsibility*** is confined to the expression of an opinion, and the adequacy of auditing procedures.
4. Purpose of the ordinary examination is not primarily the detection of fraud. Auditor is aware that fraud may exist and as such may affect the financial statements. The auditor must assess the risk that fraud may have affected the financial statements, and as such, the auditor would appropriately modify the audit procedures. (See S.A.S. No. 82 for a complete discussion of the auditor's responsibility to detect fraud.)

GENERALLY ACCEPTED AUDITING STANDARDS

Auditing "standards" differ from auditing "procedures" in that procedures relate to acts to be performed, whereas standards deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken. The generally accepted auditing standards, which are interdependent and interrelated, are represented by the general standards, field standards, and reporting standards from the time the Auditing Standards Board of the AICPA will issue interpretations of the standards in publications known as Statements on Auditing Standards (SAS's).

General Standards

1. The examination is to be performed by a person or persons having ***adequate technical training and proficiency*** as an auditor.
2. In all matters relating to the assignment an ***independence*** in mental attitude is to be maintained by the auditor or auditors.
3. ***Due professional care*** is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. ***The work is to be adequately planned,*** and assistants, if any, are to be properly supervised.
2. The auditor should obtain a sufficient ***understanding of the internal control structure*** to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent ***evidential*** matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with ***generally accepted principles of accounting.***
2. The report shall identify those circumstances in which such principles have not been ***consistently*** observed in the current period in relation to the preceding period.
3. ***Informative disclosures*** in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an ***expression of opinion*** regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

OVERVIEW OF THE AUDIT PROCESS

A. **Decision to Accept Client**

Decision Criteria

1. Independence
   Rule 101 Code of Ethics
   GAAS
2. Competency
   Rule 201 Code of Ethics
   GAAS
3. Predecessor Auditor

B. **Document Engagement Understanding**
(Engagement Letter)

C. **Plan Audit**

1. Obtain Information on:
   a. Management
   b. Industry
   c. Regulation
   d. Economy
   e. Outside pressure

Decision on Audit Risk
a. Potential for Errors
b. Potential for Illegal Acts
c. Potential for Fraud

2. Perform Analytical Review
3. Initial Understanding of Internal Control
4. Audit Program
   1) Preliminary based upon 1-3 and planned level of reliance on Internal Controls
   2) Detail nature, timing and extent of Tests

D. **Consider Internal Controls**

↓

Outcomes

Plan level of Reliance needs to be modified	Confirms Planned level of reliance
↓	↓
Update Planned Audit Program Developed in C4 above	Go with original plan as developed in C4 above

E. **<u>Perform Substantial Audit Tests</u>**

- A ← Extraordinary Results
  1. Errors
  2. Fraud
  3. Illegal Acts
- Nothing extraordinary encountered

A ↓ Update Programs after discussions with client

F. **<u>Obtain Representation Letter</u>**

G. **<u>Propose Necessary Adjusting Entries</u>**

- Rejected By client ↓ Modify opinion appropriately
- Accepted By client ↓ Issue unqualified opinion

DECISION TO ACCEPT A CLIENT

The decision to accept an engagement is made by reference to the General Standards of G.A.A.S. and by consultation with the predecessor auditor, if applicable.

GENERAL STANDARDS

The general standards are concerned with the professional training and conduct of the auditor. Specifically, there are three general standards:

1. The examination is to be performed by a person or persons having adequate **technical training** and **proficiency** in auditing.
   (This is normally interpreted to mean that the auditor has adequate formal training and a knowledge of the accounting principles used by the client.)
2. In all matters relating to the assignment, an **independence** in mental attitude is to be maintained by the auditor or auditors.
   (Since the auditor is attesting to the fairness of the financial statements, it is important that he have no bias towards the client. If the CPA is not independent of his client he must disclaim an opinion.)
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Chapter One contains additional text that has been omitted from this sample chapter.

Excerpt from Volume 3—Auditing

Chapter One – Questions
Introduction, General and Field Standards

1. Tests of controls are performed in order to determine whether or not
a. Controls are functioning as designed.
b. Necessary controls are absent.
c. Incompatible functions exist.
d. Material dollar errors exist.

2. For good internal accounting control, which of the following functions should **not** be the responsibility of the treasurer's department?
a. Data processing.
b. Handling of cash.
c. Custody of securities.
d. Establishing credit policies.

3. During an audit an internal auditor may provide direct assistance to an independent CPA in

	Obtaining an understanding of the internal control structure	*Performing tests of controls*	*Performing substantive tests*
a.	No	No	No
b.	Yes	No	No
c.	Yes	Yes	No
d.	Yes	Yes	Yes

4. Which of the following statements regarding auditor documentation of the client's system of internal control is correct?
a. Documentation must include flow charts.
b. Documentation must include procedural writeups.
c. No documentation is necessary although it is desirable.
d. No one particular form of documentation is necessary, and the extent of documentation may vary.

5. It would be appropriate for the payroll accounting department to be responsible for which of the following functions?
a. Approval of employee time records.
b. Maintenance of records of employment, discharges, and pay increases.
c. Preparation of periodic governmental reports as to employees' earnings and withholding taxes.
d. Distribution of pay checks to employees.

6. Operating control over the check signature plate normally should be the responsibility of the
a. Secretary.
b. Chief accountant.
c. Vice president of finance.
d. Treasurer.

7. Internal control over cash receipts is weakened when an employee who receives customer mail receipts also
a. Prepares initial cash receipts records.
b. Records credits to individual accounts receivable.
c. Prepares bank deposit slips for all mail receipts.
d. Maintains a petty cash fund.

8. Which of the following **best** describes proper internal control over payroll?
a. The preparation of the payroll must be under the control of the personnel department.
b. The confidentiality of employee payroll data should be carefully protected to prevent fraud.
c. The duties of hiring, payroll computation, and payment to employees should be segregated.
d. The payment of cash to employees should be replaced with payment by checks.

9. Transaction authorization within an organization may be either specific or general. An example of specific transaction authorization is the
a. Establishment of requirements to be met in determining a customer's credit limits.
b. Setting of automatic reorder points for material or merchandise.
c. Approval of a detailed construction budget for a warehouse.
d. Establishment of sales prices for products to be sold to any customer.

10. Effective internal control over purchases generally can be achieved in a well-planned organizational structure with a separate purchasing department that has
a. The ability to prepare payment vouchers based on the information on a vendor's invoice.
b. The responsibility of reviewing purchase orders issued by user departments.
c. The authority to make purchases of requisitioned materials and services.
d. A direct reporting responsibility to the controller of the organization.

11. An example of an internal control weakness is to assign to a department supervisor the responsibility for
a. Reviewing and approving time reports for subordinate employees.
b. Initiating requests for salary adjustments for subordinate employees.
c. Authorizing payroll checks for terminated employees.
d. Distributing payroll checks to subordinate employees.

12. The independent auditor should acquire an understanding of a client's internal audit function to determine whether the work of internal auditors will be a factor in determining the nature, timing, and extent of the independent auditor's procedures. The work performed by internal auditors might be such a factor when the internal auditor's work includes
a. Verification of the mathematical accuracy of invoices.
b. Review of administrative practices to improve efficiency and achieve management objectives.
c. Study and evaluation of internal accounting control.
d. Preparation of internal financial reports for management purposes.

13. It is important for the CPA to consider the competence of the audit clients' employees because their competence bears directly and importantly upon the
a. Cost/benefit relationship of the system of internal control.
b. Achievement of the objectives of the system of internal control.
c. Comparison of recorded accountability with assets.
d. Timing of the tests to be performed.

14. Which of the following would be **least** likely to be included in an auditor's tests of controls?
a. Inspection.
b. Observation.
c. Inquiry.
d. Confirmation.

15. Tests of controls are concerned primarily with each of the following questions **except**
a. How were the procedures performed?
b. Why were the procedures performed?
c. Were the necessary procedures performed?
d. By whom were the procedures performed?

16. Which of the following is a primary function of the purchasing department?
a. Authorizing the acquisition of goods.
b. Ensuring the acquisition of goods of a specified quality.
c. Verifying the propriety of goods acquired.
d. Reducing expenditures for goods acquired.

17. An auditor uses the knowledge provided by the understanding of internal control and the final assessed level of control risk primarily to determine the nature, timing, and extent of the
a. Attribute tests.
b. Compliance tests.
c. Tests of controls.
d. Substantive tests.

18. When control risk is assessed at the maximum level for all financial statement assertions, an auditor should document the auditor's

	Understanding of the entity's internal control components	*Conclusion that control risk is at the maximum level*	*Basis for concluding that control risk is at the maximum level*
a.	Yes	No	No
b.	Yes	Yes	No
c.	No	Yes	Yes
d.	Yes	Yes	Yes

19. Which of the following controls would be most effective in assuring that recorded purchases are free of material errors?
a. The receiving department compares the quantity ordered on purchase orders with the quantity received on receiving reports.
b. Vendors' invoices are compared with purchase orders by an employee who is independent of the receiving department.
c. Receiving reports require the signature of the individual who authorized the purchase.
d. Purchase orders, receiving reports, and vendors' invoices are independently matched in preparing vouchers.

Chapter One contains additional questions, problems/simulations that have been omitted from this sample chapter.

Excerpt from Volume 3—Auditing

Chapter One - Solutions to Questions Introduction, General and Field Standards

1. (a) Tests of controls are designed to determine whether the control procedures prescribed by the client are actually functioning. An example of a test of controls would be to examine purchase orders for proper authorization.

2. (a) Data processing is a recording function and thus should be under the direction of the controller. Answers (b), (c) and (d) are functions of the treasurer's department since they are "custodial" in nature.

3. (d) In performing an audit, the CPA may request direct assistance from internal auditors. For example, internal auditors may assist the independent CPA in obtaining an understanding of the internal control structure or in performing tests of controls or substantive tests.

4. (d) The auditor is required to assess the internal control structure as part of the audit process. The documentation provides evidence that the auditor has complied with the second standard of field work. The extent and type of documentation is left to the auditor's judgment.

5. (c) This department has access to the records necessary to prepare payroll tax reports.

6. (d) Treasurer is responsible for cash disbursements.

7. (b) There is a control weakness because the employee has both custody of an asset (cash) and the accounting record (accounts receivable subsidiary ledgers).

8. (c) The authorization of transactions, record keeping, and custodial functions should be segregated.

9. (c) Special authorization refers to a certain item. General authorization refers to classes of items.

10. (c) Purchasing agent has authority to purchase, not authority to initiate purchases.

11. (d) Department supervisor authorizes payroll and should not be responsible for distribution (custodial function—custody of checks).

12. (c) The work of internal auditors is a part of, but not a substitute for, the independent auditor's evaluation of internal control. Answer (a) is work not necessarily performed by internal auditors. Answers (b) and (d) do not directly affect internal accounting control.

13. (b) One of the basic elements of an adequate system of internal control is competent personnel with clear lines of authority and responsibility.

14. (d) Inquiry is the first step in determining the client's control system. The system is then tested by applying the procedures detailed in answers (a) and (b). Answer (d) is used to verify balances, not test controls.

15. (b) The question deals with the primary questions asked in testing controls. The auditor is least concerned with why. He performs the procedures because he is concerned with control which centers primarily on how, where and who, as opposed to why (this is answered in the understanding of the system).

16. (b) The purchasing department's function is solely to purchase previously authorized goods and services at the desired quality and best price. They have no function in authorization for purchase receiving or payment.

17. (d) Substantive tests are audit tests performed to substantiate the fairness of presentation of each account on the financial statements. The nature, timing, and extent of substantive tests is determined by the creditor's assessment of control risk. Answers (a), (b) and (c) are synonymous terms, and these tests are used to determine whether internal control procedures are actually in place in the client's operation.

18. (b) GAAS requires that the auditor understand the entity's control structure elements and to document the assessed level of control risk. If control risk is assessed at the maximum, no reasons need to be stated. However, if control risk is assessed at less than the maximum, the reasons for assessing it at less than the maximum must be documented.

19. (d) In order to prevent material errors in recording purchases, an employee who is independent of the purchasing or receiving function should compare the quantity purchased with the quantity received and the quantity billed by the vendor. This is the function of the accounts payable clerk.

20. (b) A material weakness is a condition where control procedures are not suitably designed or operating effectively to prevent or detect an error or irregularity in the normal course of business by employees performing their assigned duties. Therefore, accounting records and financial statements may be incorrect. A reportable condition is a situation in the control structure that may be designed ineffectively or not operating properly, but the deficiency has no effect on the timely recording and summarizing accounting transactions. According to GAAS, both situations a material weakness and a reportable condition are reportable conditions, but a reportable condition may not be a material weakness.

21. (c) Answers (a), (b) and (d) are incorrect because the auditor can ascertain that these controls are in place by other means through records available within the company. However, in order to determine whether a given employee actually exists, the auditor must observe the actual distribution of checks and would usually include the employee providing some form of personal identification.

22. (b) The auditor may document his understanding of the client's internal control through the use of a narrative, internal control questionnaire or flowchart or any other appropriate means. Therefore, answer (b) is the correct answer.

23. (a) The purpose of tests of controls is to provide reasonable assurance that internal controls are being applied as determined by the auditor during the review of the internal control structure.

24. (b) The payroll accounting department has a recording responsibility and as such it should not have custody of unclaimed payroll checks (custody of an asset). If the payroll accounting department had custody of payroll checks, its employees could add a fictitious employee to the payroll and subsequently obtain the check.

25. (a) In an organizational structure, the personnel department is delegated the authorization power over pay rates.

26. (d) In order to evaluate the objectivity of internal auditors, it is necessary for the independent CPA to determine the organizational level to which the internal auditor reports. If, for example, the internal auditor reports to the controller, it would be impossible for the internal auditor to be objective.

27. (b) The receiving department copy of the purchase order should be "blind" (i.e., quantities omitted). This ensures that the receiving department personnel count the incoming merchandise. Thus the company will end up paying only for what was received, which may not be what was billed by the vendor.

28. (a) Control procedures over the payroll function include the reconciliation of job time tickets to employee clock card hours. Answer (b) is incorrect because the reconciliation should be done by the payroll department, not the individual employee responsible for those jobs.

Chapter One contains additional answers that have been omitted from this sample chapter.

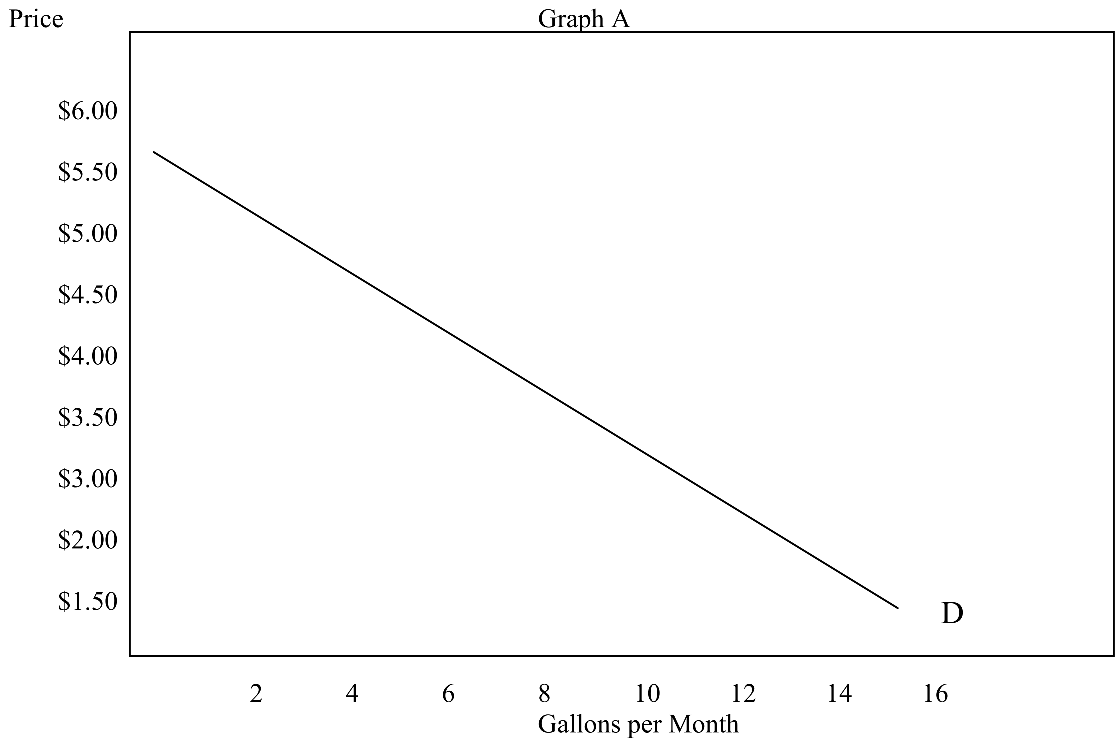
Excerpt from Volume 4—Business Environment and Concepts

Chapter Three
Microeconomics with Strategy Emphasis

Market Influences on Business Strategies, Including Selling, Supply Chain, and Customer Management Strategies

An understanding of micro-economics (the economics of the firm) starts with an understanding of the demand and supply curves and their intersection to determine the equilibrium price. Let us review by examining a family's demand curve for a commodity product such as milk in a regional marketing area such as New York City. The graph below illustrates the demand curve.

Demand Curve for Milk in New York City



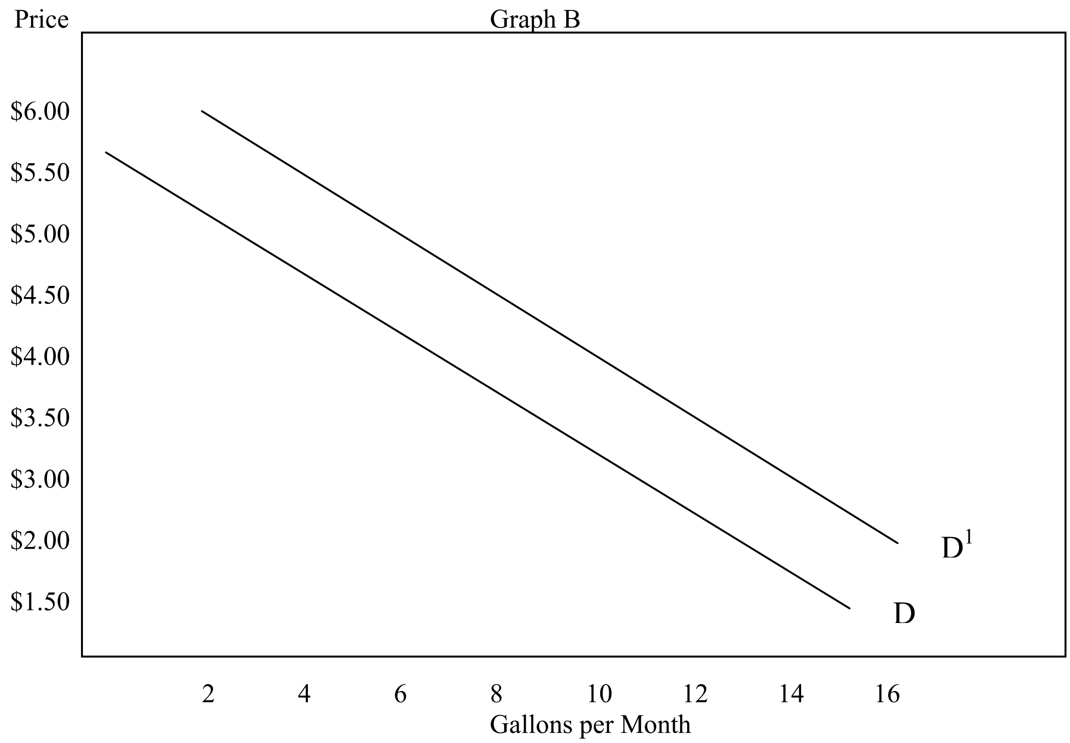
The demand curve in graph A, above is illustrated by the line that is downward sloping to the right (D). The demand curve is downward sloping because of the law of diminishing marginal utility. The law of diminishing marginal utility recognizes that the total satisfaction derived from the consumption of milk (or any good) will initially increase as more of the good is consumed and then total satisfaction will start to diminish. The diminishing total satisfaction is reflected in the demand curve in that as the quantity per month increases, the consumer will be willing to pay less for the next additional unit of the good. The consumer might be willing to pay $3.50 per gallon for 8 gallons of milk per month, but would only be willing to purchase the ninth gallon of milk per month at some price less than $3.50 per gallon.

From a strategic viewpoint, businesses seek to shift the demand curve to the right in order to sell a larger quantity at the same price or the same quantity at a higher price. The various ways that a demand curve might shift to the right are the following:

1. Increase in the number of consumers
2. A change in tastes in favor of the good
3. Increase in the price of substitutes
4. An increase in the income of consumers

A shift in the demand curve should be contrasted with a change in quantity demanded on the same demand curve. A **shift in the demand curve** to the right signals that at each price point the consumer is willing to buy a larger quantity of the good. On the other hand, a **change in quantity demanded** refers to a change in demand on a particular demand curve. A change in quantity demanded may be illustrated by reference to graph A. Given the demand curve in graph A, a change in price from $3.50 per gallon to $3.00 per gallon will result in an increase in quantity demanded from 8 gallons per month to 10 gallons per month. Thus, the term "change in quantity demanded" does not refer to a situation in which the demand curve has shifted. Graph B below illustrates the shift in the demand curve from D to D^1.

Demand Curve for Milk in New York City



When you contrast demand curve D with demand curve $D^{1,}$ it is clear that for all price points the quantity demanded is greater for demand curve D^1 than it is for demand curve D. That demand curve shift to the right could have been caused by any of the four causes mentioned earlier.

The slope of the demand curve is of particular importance from a strategic perspective. Demand curves tend to be either elastic or inelastic. An elastic demand curve suggests that a small percentage change in price will result in a larger percentage change in quantity demanded. Using the demand curve in graph A, we can calculate the **price elasticity of demand** for the situation in which the price declines from $3.50 per unit to $3.00 per unit. Graph A shows that the quantity of 8 gallons is associated with the $3.50 per gallon price and the quantity of 10 gallons is associated with the $3.00 price. The coefficient of the price elasticity of demand for that portion of the demand curve is calculated using the following equation:

Percentage change in quantity / Percentage change in price

The decline in price from $3.50 to $3.00 results in a $.50 change in price. That represents the following percentage change in price:

$.50 / Average of $3.50 and $3.00 =

$.50 / $3.25 = 15.38%

The increase in quantity from 8 gallons (associated with the $3.50 price) to 10 gallons (associated with the $3.00 price) represents the following percentage change in quantity demanded:

2 gallon change / Average of 8 gallons and 10 gallons =

2 gallons / 9 gallons = 22.22%

Therefore the price elasticity of demand is

22.2% change in quantity / 15.38% change in price = 1.44

Therefore the coefficient of the price elasticity of demand for that price change is 1.44. A coefficient greater than one suggests an elastic demand curve and a coefficient less than one suggests an inelastic demand curve.

It is important to remember that the equation for calculating the coefficient of the price elasticity of demand has the Quantity on the top and the Price on the bottom. To help you remember, think of a man that has his tie tied too tightly. It is so tight that his tongue is hanging out as in Q for quantity. The P (price) represents the tie around his neck.

Inelastic demand is represented by a coefficient of price elasticity of demand that is less than 1. In such a situation the demand curve would tend to be more vertical than the one shown in graph A. The demand curve for coffee would likely be more vertical than the demand curve for milk given that there is more of a tendency for the caffeine in coffee to be slightly addictive. The inelastic demand curve suggests that a large percentage change in price will result in a relatively small percentage change in quantity demanded.

The difference between elastic and inelastic demand may also be examined in terms of the total revenue before and after a price change. In the example in which the price changed from $3.50 to $3.00, the quantity changed from 8 gallons to 10 gallons. The revenue associated with the $3.50 price was $28 ($3.50 X 8 gallons) and the revenue associated with the $3.00 price was $30 ($3.00 X 10 gallons). Thus, for this relatively elastic demand curve (in the interval of $3.50 to $3.00 per gallon) illustrated in graph A, the decline in price resulted in an increase in revenue by $2. ($30- $28). This focus on revenues permits us to draw the following conclusions concerning the relationship between revenue and price elasticity of demand:

If the demand curve…	and…	then…
Is elastic	Price falls	Revenue increases
Is elastic	Price rises	Revenue decreases
Is inelastic	Price falls	Revenue decreases
Is inelastic	Price rises	Revenue increases

Demand is more elastic for goods that have multiple substitutes and less elastic for goods with relatively few substitutes. A strategy used by many companies is one that attempts to convince potential customers that the company's product is sufficiently differentiated from other products that there is no suitable substitute product. The company is attempting to create a relatively inelastic demand curve for the product. An inelastic demand curve would permit the company to increase price and thus increase revenues. In contrast, an elastic demand curve would result in a decrease in revenues if price were increased.

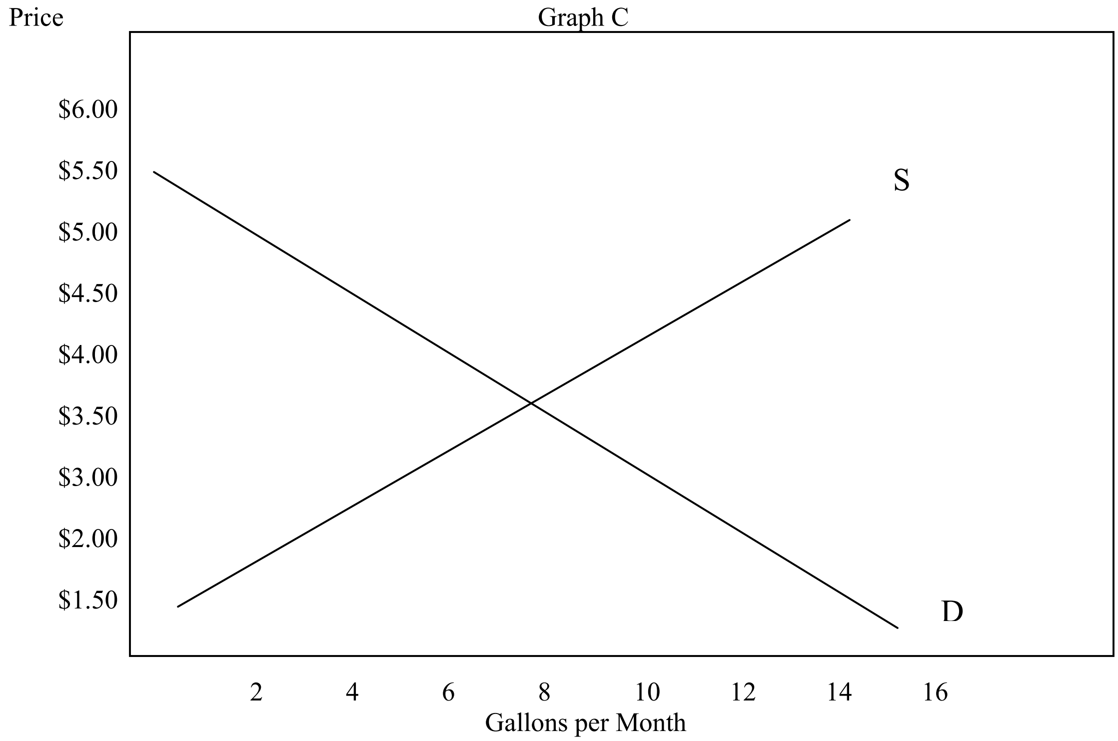
Demand also tends to be more inelastic in the short run because it takes time to identify suitable substitutes. Thus, the demand for a product tends to be more elastic in the long run than it is in the short run. Thus, a strategy of raising prices to take advantage of a relatively inelastic demand curve in the short run could be counterproductive. The higher prices could attract competitors and the competitors would offer suitable substitute products. In the long run, the demand curve could become elastic because of the increased substitutes. Thus, the exploitation of an inelastic demand curve may only be profitable in the long term if the company can sustain a competitive advantage.

High value products are more likely to have elastic demand curves than are low value products. For high value products, such as automobiles, the consumer is more likely to shop around for substitute products because the potential savings associated with "shopping around" are likely to be great. On the other hand, the potential savings from shopping around for low value products, such as candy bars, is not nearly as great.

Now that we have dealt with the demand curve, it is time to turn to the supply curve. The supply curve slopes upward and to the right as shown in graph C. The intersection of the demand and supply curves is at a price of $3.50 and a quantity of 8 gallons per month. The intersection of the demand and supply curves is called the "price equilibrium point" and it determines the price at which the good will be sold and the quantity which will be sold.

Demand and Supply Curves for Milk in New York City

Graph C



The supply curve slopes upward as a result of the tendency for marginal costs to increase as the quantity produced increases. The law of diminishing returns is the basis on which marginal costs increase. Given a fixed amount of production resources (equipment and buildings), the addition of increments of labor will produce diminishing returns. Those diminishing returns translate into higher marginal costs as the quantity increases. Thus, with increasingly higher marginal cost, a producer would only be induced to produce a larger quantity if the price of the product were sufficiently high. The price has to exceed the marginal cost of the next unit of product produced in order to induce the producer to supply a larger quantity.

Just like demand curves, supply curves may shift to the right or to the left. A shift to the right implies that a larger quantity will be supplied for every price point on the supply curve. A shift to the left implies that a smaller quantity will be supplied for every price point on the supply curve. Listed below are the various causes of a supply curve shift:

- Price of input resources – if the price of input resources declines, the marginal cost declines and the supply curve will shift to the right. A larger quantity will be offered at each price point.

- Number of suppliers – if the number of suppliers increases, the supply curve will shift to the right. In this case, the marginal cost has not changed but more is supplied because of a greater number of suppliers.

Chapter Three contains additional text that has been omitted from this sample chapter.

Excerpt from Volume 4—Business Environment and Concepts

Chapter Three
Microeconomics with Strategy Emphasis
Multiple Choice Questions[1]

1. The demand for a good or service depends on all the following factors EXCEPT:
a. The cost to produce it.
b. The price of the item.
c. The tastes of consumers.
d. The prices of substitute and complementary goods.

2. Which of the following statements concerning the relationship of the quantity demanded or supplied with price is (are) correct?
(1) The quantity supplied varies inversely with price.
(2) The quantity demanded varies directly with price.

a. (1) only
b. (2) only
c. Both (1) and (2)
d. Neither (1) nor (2)

3. According to economic theory, which of the following statements is correct?
a. A price in excess of the equilibrium price would lead to a shortage of supply.
b. A price in excess of the equilibrium price would lead to an excess of demand.
c. An equilibrium price can be disrupted by a rightward or leftward shift of the supply or demand curve.
d. An equilibrium price is the price at which all consumers are able to buy as much as they want.

4. A shift in the supply curve downward and to the right, with the demand curve unchanged, will lead to which of the following results?
(1) An increase in the equilibrium price
(2) A decrease in the equilibrium quantity

a. (1) only
b. (2) only
c. Both (1) and (2)
d. Neither (1) nor (2)

5. When building contractors decide *not* to build on speculation but only when a contract to build is executed, it is a signal that wage inflation may be causing a rise in building costs. One may conclude from this scenario that:
a. The supply curve will remain static as wage inflation increases demand.
b. The quantity of new homes demanded will decrease, prices will rise, and the supply curve will shift to the left.
c. The supply curve will shift downward but prices will rise.
d. The quantity of homes built will decrease along with the price of housing.

6. Supply Chain Management systems rely upon which of the following?
a. Many suppliers.
b. Frequent competitive bidding.
c. Cooperation between purchasing and suppliers.
d. Short-term contracts.

7. If both the supply and the demand for a good increase, the market price will
a. rise only in the case of an inelastic supply function.
b. fall only in the case of an inelastic supply function.
c. not be predictable with only these facts.
d. rise only in the case of an elastic demand function.

8. The sum of the average fixed costs and the average variable costs for a given output is known as
a. long-run average cost.
b. average product.
c. total cost.
d. average total cost.

[1] Material from *Economics* (Bank 1 t/a) by McConnell, published by McGraw Hill, copyright ©2002, is reproduced with permission of the McGraw-Hill Companies.

9. In any competitive market, an equal increase in both demand and supply can be expected to always
a. increase both price and market-clearing quantity.
b. decrease both price and market-clearing quantity.
c. increase market-clearing quantity.
d. increase price.

10. A perfectly inelastic supply curve in a competitive market
a. means the equilibrium price must be zero.
b. says the market supply curve is horizontal.
c. exists when firms cannot vary input usage.
d. can only exist in the long run.

11. Government price regulations in competitive markets that set maximum or ceiling prices below the equilibrium price will in the short run
a. cause demand to decrease.
b. cause supply to increase.
c. create shortages of that product.
d. have no effect on the market.

12. In competitive product markets, equilibrium price in the long run is
a. a fair price all consumers can afford.
b. set equal to the total costs of production.
c. set equal to the total fixed costs of production.
d. set equal to the marginal costs of production.

13. In the theory of demand, the marginal utility per dollar of a product
a. increases when consumption expands.
b. decreases when consumption expands.
c. is used to explain why demand curves are vertical.
d. explains why short-run supply curves are upward sloping.

14. In the short run, the supply curve in a competitive market shows a positive relationship between price and quantity supplied because
a. a higher price causes an increase in demand so the market stays in equilibrium.
b. of the law of diminishing returns.
c. as the size of a business firm increases, price must rise.
d. increases in output imply a shift in consumer preferences allowing a higher price.

15. Because of the existence of economies of scale, business firms may find that
a. each additional unit of labor is less efficient than the previous unit.
b. as more labor is added to a factory, increases in output will diminish in the short run.
c. increasing the size of a factory will result in lower average costs.
d. increasing the size of a factory will result in lower total costs.

16. Economic markets that are characterized by monopolistic competition have all of the following characteristics EXCEPT
a. one seller of the product.
b. economies or diseconomies of scale.
c. heterogeneous products.
d. downward-sloping demand curves for individual firms.

17. When markets are perfectly competitive, consumers
a. must search for the lowest price for the products they buy.
b. have goods and services produced at the lowest cost in the long run.
c. must choose the brands they buy solely on the basis of informational advertising.
d. do not receive any consumer surplus unless producers choose to overproduce.

18. The manner in which cartels set and maintain price above the competitive market price is to
a. avoid product differentiation in order to decrease demand for the product.
b. advertise more so market demand increases.
c. encourage the introduction of higher-priced substitute products.
d. require cartel members to restrict output.

19. In a competitive market for the labor where demand is stable, if workers try to increase their wage,
a. employment must fall.
b. labor supply must increase.
c. government must set a maximum wage below the equilibrium wage.
d. firms in the industry must become smaller.

Chapter Three contains additional questions that have been omitted from this sample chapter.

Excerpt from Volume 4—Business Environment and Concepts

Chapter Three
Microeconomics with Strategy Emphasis
Answers to Multiple Choice Questions

1. Answer (a) is the correct answer. The cost to produce an item is a determinant of the supply curve for the item. Answer (b) is not correct because the price of the item is a determinant of the demand for an item. Answer (c) is not correct because the tastes of the consumer is a determinant of demand. Answer (d) is not correct because the prices of substitute and complementary goods is a determinant of demand.

2. Answer (d) is the correct answer. The quantity supplied varies directly with price and the quantity demanded varies indirectly with price. Answer (a) is not correct because the quantity supplied varies directly with price. Answer (b) is not correct because the quantity demanded varies indirectly with price. Answer (c) is not correct because the quantity supplied varies directly with price and the quantity demanded varies indirectly with price.

3. Answer (c) is the correct answer. An equilibrium price can be disrupted by any change in the supply and or the demand curve. Answer (a) is not correct because such a price would lead to a surplus. Answer (b) is not correct because such a price would lead to a deficiency in demand. Answer (d) is not correct because an equilibrium price leads to an equality of the quantities demanded and supplied, not necessarily (or even likely) a complete satisfaction of consumer demand for the good or service.

4. Answer (d) is the correct answer. A downward and to the right shift in the supply curve with no change in the demand curve will result in a lower price and a larger equilibrium quantity. Answer (a) is not correct because a downward and to the right shift in the supply curve with no change in the demand curve will decrease the equilibrium price. Answer (b) is not correct because a downward and to the right shift in the supply curve with no change in the demand curve will result in an increase in the equilibrium quantity. Answer (c) is not correct because a downward and to the right shift in the supply curve with no change in the demand curve will result in a lower price and a larger equilibrium quantity.

5. Answer (b) is the correct answer. The supply curve will shift to the left, the demand curve will remain unchanged, prices will increase and the quantity demanded will decline. Answer (a) is not correct because the supply curve will shift to the left and speculative homes are no longer built. Answer (c) is not correct because a downward shift in the supply curve would suggest an increased supply at all price points (contrary to the removal of speculative homes) and an increased supply would imply a reduction in price. Answer (d) is not correct because the supply curve will shift to the left as speculative homes are no longer constructed. That shift in the supply curve with no change in the demand curve will result in an increase in price.

6. Answer (c) is the correct answer. Supply Chain Management systems are based on purchasers and suppliers working together under long-term contracts to reduce the cost of the product or service and also to reduce the cost of the delivery and documentation. Answer (a) is not correct because under Supply Chain Management systems purchasing managers establish partnerships with one or few suppliers. Answer (b) is not correct because under Supply Chain Management systems the purchasing manager and the supplier enter into a long-term contract to induce the supplier to participate as a partner with the purchaser. Answer (d) is not correct because in order to establish a partnership between the purchaser and the supplier, there is a need for long-term contracts.

7. (c) is the correct answer. The effect on the market price will only be predictable when the extent of the change in demand or supply is known. That information is not given among the choices. Answer (a) is not correct because the increase in supply is inconsistent with an inelastic supply function. Answer (b) is not correct because the increase in supply is inconsistent with an inelastic supply function. Answer (d) is not correct because the increase in demand is inconsistent with an inelastic demand function.

8. (d) is the correct answer. Explicit costs are of two types—fixed costs and variable costs. The sum of the average fixed costs and average variable costs is equal to the average total costs. Answer (a) is not correct because the long-run average cost includes opportunity costs. Answer (b) is not correct because average product is the total physical product divided by the number of units of the factor employed. Answer (c) is not correct because the total cost is the sum of the total variable costs and the total fixed costs.

9. (c) is the correct answer. The market clearing quantity is the quantity purchased which leaves no frustrated consumers. If the increase in both demand and supply were equal, that increase in supply would be purchased and there would be no frustrated consumers. Thus, the quantity purchased would increase. Answer (a) is not correct because it is not likely that the price would increase because the supply increased. Answer (b) is not correct because it is not likely that the price would decrease because the demand increased. Answer (d) is not correct because both demand and supply increase equally.

10. (c) is the correct answer. A perfectly inelastic supply curve is a vertical line; and it implies that a change in price will not impact the quantity offered in the market. That would be the case where firms cannot vary input usage. Answer (a) is not correct because an equilibrium price of zero would mean that it is a free good. Answer (b) is not correct because a horizontal supply curve is used to represent a perfectly elastic supply curve, not an inelastic one. Answer (d) is not correct because a perfectly inelastic supply curve is more likely to occur in the short run, than in the long run. In the long run, producers may be able to adjust to lower or higher demand for the product.

11. (c) is the correct answer. If the maximum price is set below the equilibrium price, the supply will not be sufficient to meet the demand. Thus, there will be a shortage of the product. Answer (a) is not correct because demand is independent of supply. Answer (b) is not correct because supply will not increase if the market-clearing price cannot be realized. Answer (d) is not correct because regulations that set minimum prices are likely to have an impact on the market in most situations.

12. (d) is the correct answer. In a competitive market, the forces of demand and supply will, in the long run, cause price to equal marginal cost. If price is higher than marginal cost, additional production will be forthcoming. If price is lower than marginal cost, producers will quit producing. Answer (a) is not correct because a competitive market cannot assure a fair price that all consumers can afford. The disposable income of the consumers dictates whether or not they can afford the product at the equilibrium price. Some will be able to afford it and some will not. Answer (b) is not correct because a price set equal to the total cost of production fails to recognize that the total cost should be divided by the number of units produced. Answer (c) is not correct because a price set equal to the total fixed cost of production fails to recognize that the total fixed cost should be divided by the total number of units produced. Even then, the variable costs per unit would be ignored.

13. (b) is the correct answer. The principle of diminishing marginal utility states that additional utility declines as quantity consumed increases. Answer (a) is not correct because the principle of diminishing marginal utility states just the opposite is true. One tires of something the more he or she has of it. Answer (c) is not correct because a vertical demand curve implies that the demand remains unchanged as price changes. That is contrary to the principle of diminishing marginal utility. Answer (d) is not correct because it implies that marginal utility increases as supply increases. Utility is independent of supply.

14. (b) is the correct answer. In the short run the addition of variable inputs to fixed resources yields additional output; but the amount of additional output diminishes as more variable inputs are used. Thus, as price increases, the amount of product supplied will increase until the marginal cost is equal to the marginal revenue. Answer (a) is not correct because a higher price does not usually cause an increase in demand. The increase in demand is what would likely cause a higher price. Answer (c) is not correct because as the size of the business firm increases, the price must fall if the demand remains unchanged. Answer (d) is not correct because increases in supply do not always imply a shift in consumer preference; it could be caused by the entry of a new producer in pursuit of excess profits.

15. (c) is the correct answer. Economies of scale are declines in long-run average costs that are caused by increased plant size. Answers (a) and (b) are not correct because they describe the law of diminishing returns. Answer (d) is not correct because increasing the size of the factory might lower average costs, but it will not lower total costs.

Chapter Three contains additional answers that have been omitted from this sample chapter.

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