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CPA Exam

2nd Edition

by Kenneth W. Boyd, CPA

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CPA Exam For Dummies®, 2nd Edition

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Introduction

So you're interested in becoming a CPA, huh? Good for you! A CPA certification opens all kinds of doors for you professionally that are closed to accountants without this certification. Let me warn you, though: The CPA exam is challenging. You're going to need to organize and study an enormous amount of data. Lucky for you, *CPA Exam For Dummies* makes studying for the exam easier.

About This Book

I took the CPA exam myself and passed it in the early '90s. Passing all four sections took me multiple tries. I really struggled, and I now know why. I didn't think through the process of creating and implementing a plan of study. I just dove in with no real plan of attack. I wrote this book, in part, to provide that attack plan for you.

I struggled for another reason, too. The test-prep material I used was comprehensive, covering all the topics that were on the exam in detail. What I needed was a text that explained the most frequently tested topics using examples that I could understand.

This book explains concepts by providing examples you may already understand. When my kids learned to tie their shoes, a friend of ours explained that you take the two shoestrings and "make them into elephant ears." Because our kids could visualize an elephant's big, floppy ears, the kids could make the loops to tie their shoes. They understood elephant ears, and that helped them with the shoe-tying concept. (At least two of our three children still know how to tie their shoes!)

When people ask me about test-preparation material, I explain that there are lots of great books, videos, and online resources out there. You can find some great material on the web for free. What's missing, I believe, are tools to explain these complex ideas in a simple way. I hope that you get that clear explanation out of reading this book.

I wrote this latest edition of *CPA Exam For Dummies* so that each chapter can stand on its own. If you're like me, you may glance at the table of contents of a book to find a specific topic. This book allows you to find that topic, read about it, and come back to the book later.

This book is your tool to understand and successfully complete the CPA exam, so you'll see frequent references to "you" rather than "me." Also, keep in mind that companies sell both products and services. You'll see examples using both throughout the book. Some companies are manufacturers, and some are retailers. Instead of making a product, retailers typically buy inventory and sell it.

Also note that in accounting, you'll find situations in which two or more terms mean the same thing. Here are some of the synonymous terms that you find in this book:

- » *Cost of sales* has the same meaning as *cost of goods sold*.
- » *Sales* and *revenue* mean the same thing.

- » *Indirect costs* has the same meaning as *overhead costs*.
- » *Predetermined, budgeted, and planned* all mean the same thing.
- » *Audit report* and *audit opinion* are used interchangeably.
- » *Net income* is also *profit*, for the purposes of this book.

Foolish Assumptions

I had to make some assumptions about you, the reader. As I wrote the book, here's what I assumed:

- » **You're able to follow basic arithmetic and algebra.** Some of the items you need to calculate appear in the form of equations. The CPA exam often provides numbers that you need to plug into a formula. One number in the formula isn't provided, so you use algebra to solve for the missing value.
- » **You have a beginner's level knowledge of how a business works.** You understand that sales less expenses equals profit. You're aware that a business needs to have capital (cash, equipment, and so forth) to operate.
- » **You're taking a serious look at studying for and taking the CPA exam.** This book is intended for the reader who has some interest in business or accounting and is considering adding to their skills by taking the CPA exam.
- » **You may have taken some of the tests for the exam and not passed.** You may have several test-preparation books and resources already. You need a method to plan your study, and you need key exam concepts explained more clearly.
- » **You're willing to read, pause, and assess what you've read.** Learning the concepts for the CPA exam takes some effort. It's not the sort of thing you can rush through. Although the text makes it easy to find information, understanding what you read takes some effort. Given the volume of information on the exam, you'll likely need to go over the concepts several times to commit them to memory.

Icons Used in This Book

To make this book easier to read and simpler to use, I include some icons that can help you find and fathom key ideas and information.



TIP

This icon appears whenever an idea or item can help reinforce your understanding of a concept. A Tip may make it easier to remember a topic.



REMEMBER

Whenever you see this icon, you know the information that follows is so important that it's worth reading more than once.



WARNING

Pay attention to the Warning icon to avoid pitfalls on the CPA exam.

Beyond the Book

In addition to what you're reading right now, this book comes with a free access-anywhere Cheat Sheet that includes tips to help you prepare for the CPA exam. To get this Cheat Sheet, simply go to www.dummies.com and type **CPA Exam For Dummies Cheat Sheet** in the Search box.

You also get access to extra practice questions for each of the six possible tests on the CPA exam, as well as dozens of flashcards to help you practice your CPA vocab. To gain access to the online practice, all you have to do is register. Just follow these simple steps:

- 1. Register your book or ebook at Dummies.com to get your PIN. Go to www.dummies.com/go/getaccess.**
- 2. Select your product from the dropdown list on that page.**
- 3. Follow the prompts to validate your product and then check your email for a confirmation message that includes your PIN and instructions for logging in.**

If you do not receive this email within two hours, please check your spam folder before contacting us through our Technical Support website at <http://support.wiley.com> or by phone at 877-762-2974.

Now you're ready to go! You can come back to the practice material as often as you want — simply log on with the username and password you created during your initial login. No need to enter the access code a second time.

Your registration is good for one year from the day you activate your PIN.

Where to Go from Here

This book is organized so that you can go wherever you want to find complete information. Need to know about the regulation test, for example? Head to Chapter 17. If you want to know about the prerequisites for taking the CPA exam, start at Chapter 3. You can use the table of contents to find broad categories of information or the index to look up more specific things.

If you're not sure where you want to go, you may want to start with Part 1. It gives you all the basic info you need to understand the CPA exam and points to places where you can find more-detailed information.

1

**Getting Started
with the CPA
Exam**

IN THIS PART . . .

Find out what it takes to become a CPA — and why all the work is worth it.

Become familiar with the structure of the exam and what types of skills it tests.

Find out how to register for the exam and what to expect when you arrive on test day.

Put together a study plan that works around your busy life to ensure that you're as successful as possible on the exam.

Get to know the types of questions you'll see on the exam so that you can answer them with confidence.

- » Considering the benefits of a CPA designation
- » Mulling over what a CPA does
- » Weighing the CPA credential with other designations

Chapter **1**

So You Want to Become a CPA

A *certified public accountant*, or CPA, is a valuable credential in the world of accounting and finance. To gain the credential, a candidate must pass the CPA exam. Before you put in the work to prepare for the exam, though, make sure you understand the CPA designation.

In this chapter, you discover the added responsibilities that may come with a CPA designation. CPAs have a higher level of expertise and responsibility than non-CPA accounting professionals. As a result, many senior-level accounting positions require a CPA. Next, you go over the type of work that CPAs perform. The designation allows you to work in a variety of accounting positions. Finally, you look at a comparison of the CPA credential to other designations in the accounting profession.

Added Responsibilities with a CPA Designation

A CPA designation can allow you to advance your career beyond those people who simply earn an undergraduate degree. That's because the CPA exam tests you on a set of skills that are more specific than you find in an undergraduate business program. Also, the sheer amount of information tested makes passing the exam a real accomplishment. In this section, you see some of the additional responsibilities that come with a job that requires a CPA credential.

Many successful people in business, government, and the not-for-profit world started out as CPAs. That may be because CPAs understand how an entire entity works. An accountant has to understand each process within an organization, because they're responsible for posting the accounting transactions for those processes.

CPAs also generate the financial statements for the entity. To put together the statements, an accountant has to understand how the entire organization operates. It's the CPA who often must answer to stakeholders regarding the financial statements. Stakeholders include regulators,

lenders, and investors, to name a few. Here are some typical issues that a stakeholder may bring up with a CPA:

» **Balance sheet and debt:** A potential lender to the company may want details on the amount of debt a business already owes to creditors. Some lenders compare the company's *total debt to total assets*. That ratio indicates the assets a company can sell to pay off debt, assuming that the company can't make payments of principal and interest.

You can compare this situation to using a car as collateral for a loan. If the car buyer can't make the payments, the lender can sell the car to recover some (or all) of the amount loaned.

» **Stockholders and earnings:** A common-stock owner may look into the amount of earnings an entity generates. One measurement of earnings is *earnings per share* (EPS). EPS is defined as the company net profit divided by average common stock shares outstanding. This ratio explains the dollar amount of earnings that a business generates for each common stock share. *Average common stock* is defined as follows:

$$\text{Average common stock} = \frac{\left(\begin{array}{l} \text{Beginning common stock balance for the period} \\ + \text{Ending common stock balance for the period} \end{array} \right)}{2}$$

Many investors feel that EPS is an indication of a common stock's value.

» **Regulatory requirements:** Regulators require many financial institutions to maintain a certain amount of *equity*, which is defined as assets minus liabilities. To a regulator, equity represents funds available for investors. If a financial institution violates a rule or regulation, the business can repay investors using its equity.



TIP

You can understand equity using this example. Assume that a company sells all of the assets for cash and uses the cash to pay all liabilities. Any amount of cash that is left over is equity.

Considering What a CPA Does

A big advantage of the CPA credential is that it increases the variety of tasks an accountant can perform. Like many professionals, a CPA may specialize in a field or branch out into other areas of the profession.

This section explains what a CPA does and specific types of positions that are staffed by CPAs. Many of the jobs are useful in a variety of industries. Retailers and manufacturers, for example, both need tax returns and financial statements prepared. Although specific industry knowledge is important, CPAs have a set of skills that are largely transferrable.

Many businesses will hire accountants without a CPA to operate in accounting positions with less responsibility. A staff accountant handling accounts receivable or accounts payable may not have a CPA designation. Other positions with more responsibility will require a CPA. The company controller and chief financial officer are typically CPAs.

Accounting work and controller positions

One big distinction between types of accounting work is accounting versus tax. Accounting is thought of as posting transactions and generating financial statements. Tax, on the other hand, refers to tax planning and filing tax returns. This section discusses accounting work.

A chief executive officer (CEO) is responsible for hiring senior management, and one of those positions is chief financial officer (CFO). The CFO has overall responsibility for all financial matters of an organization. Here are some specific tasks that a CFO must manage:

- » **Controllership:** *Controllership* refers to maintaining control over the financial transactions of a company. The CFO needs to ensure that the accounting transactions are posted correctly. *Controllership* also refers to generating accurate and timely financial statements shortly after the end of each month and year.
- » **Treasury:** *Treasury* refers to the cash needs of a company. Businesses use debt and equity in some combination to raise *capital*, which refers to the cash and other assets the company acquires to fund the business. The decision on how much debt or equity to raise is in the hands of the CFO. The CFO plans for short-term cash needs to operate the company each month. The CFO also plans for long-term financing needs, such as planning for an expensive purchase (building, equipment, machinery, and the like).
- » **Financial strategy:** The CFO has overall responsibility for financial strategy. This includes analyzing company profit by department or product line. A CFO is expected to recommend how each department can make changes to improve profit. Because nearly every company has a limited amount of capital, the CFO needs to analyze how that capital should be used to maximize earnings. That may mean buying a new piece of equipment for Department A and closing the operations of Department B. A CFO works closely with the company's operations managers to make processes more efficient.

The CFO is both an accountant and a manager. Here are some of the positions the CFO will hire and manage:

- » **Controller and treasurer:** The CFO hires a controller to manage the accounting transactions and financial-statement process. They also hire a treasurer to manage the treasury activities.
- » **Accounting manager:** A CFO, using input from the controller, may hire one or more accounting managers. These managers are responsible for certain areas of the controllership process. One manager, for example, may handle the company's accounts receivable process. That manager processes sales, receivables, and bad-debt transactions. The position also includes reporting financial results to the controller and CFO.
- » **Staff accountant:** Accounting managers, in turn, hire staff accountants. This type of position is responsible for the day-to-day transactions of a company. If the staff accountant works with accounts receivable, they review incoming customer payments and reduce accounts receivable. That same person analyzes credit sales and posts accounts receivable. A staff accountant position may be the first position you work in as a CPA.

Not all companies have all the accounting positions I explain here. A small company may have a CFO, controller, and a few staff accountants; no accounting managers are needed to manage the company's accounting work.

Auditing, reviews, and compilations

CPAs fill the role of a third-party auditor. An *auditor* is a CPA who is independent of the company under audit. *Independence* means that the only relationship that the CPA has with the business is the fee paid for the audit. An *audit* occurs when an auditor performs procedures on the company's financial statements. The auditor uses the procedures to gather evidence about the financial statements. After completing an audit, the CPA provides a written opinion on whether the financial statements are free of material misstatement.



TIP

When discussing an audit, the word “material” refers to a misstatement (mistake) that is large enough to impact the opinion of the financial statement reader. So how large? Well, materiality is a matter of judgment. A \$200 misstatement may not get the reader’s attention, but a \$30,000 misstatement is reason to question the accuracy of the numbers.

Reviewing jobs in the field

CPA firms perform audits. These organizations are typically partnerships formed by CPAs. Here are some of the positions you find in a CPA firm:

- » **Partner:** A partner has an investment in the partnership. The partner is responsible for the management of a particular group of audit clients. Like a CFO, the partner selects an audit staff and manages the audit. Audits involve layers of review. The audit partner is responsible for the final review of the audit work.
- » **Manager:** A manager works for the partner. Each manager may be responsible for several audits that are in process at the same time. The manager reviews the work of the audit staff below them. The manager is the main contact for the audit client’s staff.
- » **Senior:** A senior has day-to-day responsibility for the audit work performed. This individual is present at the client’s offices during the audit’s fieldwork. *Fieldwork* refers to when the auditors gather evidence at the client’s offices. The auditor and the client agree on when and how long fieldwork will take place.
- » **Staff accountant:** Staff accountants perform the bulk of the audit procedures. This may include testing accounting transactions using company documents or interviewing the client’s staff. If you join a CPA firm’s audit department, you’ll probably start as a staff auditor.

Going over the audit process

When planning an audit, the CPA firm creates an audit program. An *audit program* documents the procedures that will be performed for each area of the audit. An audit of cash, for example, will include a review of the client’s bank account reconciliations. The auditor will use the bank statement and the client’s cash activity to review the reconciliation of each bank account.

Everyone involved with the CPA firm’s audit will follow the steps in the audit program. After the staff accountant or senior completes a step on the audit program, the manager and the audit partner will review the work. The senior reviews the work of each staff accountant. The multiple layers of review ensure that each step in the audit program is performed and that sufficient audit evidence has been gathered.

After the audit evidence is gathered during fieldwork, the senior and manager work on the audited financial statements. Each number in the financial statements is audited to some extent. The auditors compare their audit results with the company’s financials. If differences exist, the auditor may propose an adjustment.

An *adjustment* is a proposed accounting entry to correct the financial statements. That correction may be to fix an error or to clarify an accounting issue. Adjustments are also posted based on judgments and estimates. A bank, for example, estimates the dollar amount of loans that won’t be repaid. The bank then posts an entry to account for bad debt expense. An auditor may propose that the bad debt expense be increased or decreased.

The client can accept the adjustment and post the accounting entry. A client may also reject posting the adjustment. If the client rejects the proposed adjustment, that decision may impact the auditor’s decision on the audit opinion. For example, an auditor may feel that the dollar amount

of the adjustment requires disclosure to the financial-statement reader. The auditor may add language to the audit opinion about this area of concern.

CPA firms perform other projects that aren't considered audits, such as reviews and compilations. In these instances, the auditor isn't giving an opinion as to whether the financial statements are presented fairly. Instead, the CPA reviews the financials for proper formatting and reasonableness. If you work for a CPA firm, you'll probably work on several types of engagements.

Preparing tax returns

Besides auditing, the other large area of business for a CPA firm is tax preparation. You'll find that larger CPA firms provide both audit and tax services. Smaller firms may provide only tax services. Given the complexity of the IRS tax code, many CPAs who specialize in tax issues work on tax preparation and planning year-round.

Depending on the size of the firm, you may see the same partner, manager, senior, and staff structure that I discuss in the earlier section "Reviewing jobs in the field." If you're interested in pursuing a CPA career by opening your own small business, preparing tax returns may be a way to start.

When you consider a career in either audit or tax, keep these thoughts in mind:

» **Seasonality of tax:** Working in tax requires a tremendous number of hours between January 1 and April 15. That's because corporate and other business tax returns as well as personal tax returns are due in the March and April timeframe. To succeed as a tax preparer, you need the ability to maintain a focus on detail while working long hours.

Audit work includes heavy hours during the same timeframe. Most companies have a December 31 year-end, so the first quarter of the following year is a busy time for organizing and preparing year-end financial information. However, auditors can plan work and perform some procedures before December 31. In addition, some companies have fiscal year-ends that are at different points during the year. As a result, the work of an auditor can be more spread out during the year than tax work.

» **Less interaction:** Generally, tax preparers spend more time in the office working on technical issues. Audit, on the other hand, requires time at the client location. Fieldwork represents time at the client's offices performing work and talking to client personnel. If you're more outgoing and prefer more human interaction, audit may be a better choice than a career in tax.

» **Travel:** Auditors need to travel to client locations. Sometimes that travel may be difficult to plan and predict. If fieldwork takes longer than expected, an auditor may need to stay out of town longer. Generally, auditors try to work heavy hours while out of town. This approach allows them to finish the fieldwork as soon as possible. Tax accountants, on the other hand, generally travel much less.

Both audit and tax work require you to spend time on continuing education. As you see later in this chapter, some continuing education is required by the CPA profession. You'll need to spend even more time learning about your field. If you're an auditor, you'll learn about the industries of the clients you audit. Tax specialists need to stay on top of changes in the tax code.

Larger CPA firms have auditors who specialize in particular industries. They might, for example, develop an expertise in financial service audits. Most of the audits you work on will be in that area. As you learn more, you'll be able to complete audit procedures more quickly. You'll also be better prepared to ask the client intelligent questions.

Audit clients want the CPA firm to staff the audit with accountants who know their industry. That knowledge means that the auditor can minimize the time that they need with client personnel. The audit process goes more quickly, and the CPA firm can spend less time on fieldwork.

Branching out into other careers

CPAs often become successful leaders in a variety of fields. One reason is that accountants work with a company's entire operation. CPAs see how each department operates and how it contributes to company profit. It naturally follows that a CPA can move into company management, because they know how everything works.

Given this concept, many people obtain their CPA credential with the intention of moving into a non-accounting career. Here are just a few examples of careers that are staffed by CPAs:

- » **Company management:** Broad knowledge of a company's business allows a CPA to move into management positions. The controller of the furniture manufacturing division, for example, may be a candidate for the vice president of operations. The controller must understand operations to handle the division's accounting properly.
- » **Financial analyst:** Financial analysts perform work for company senior management. Analysts also work for investment companies that recommend stocks and bonds of other businesses as investments for their clients. Many of the skills you learn and use as a CPA are transferrable to this career.
- » **Bankers and other lenders:** Bankers and other lenders make decisions about a company's ability to generate sufficient earnings to make loan payments. Lenders analyze the balance sheet to determine whether a business has sufficient assets to serve as collateral for a loan. This work requires many of the skills used by CPAs.

Comparing a CPA to Other Credentials

Two credentials are similar to the CPA designation: chartered financial analyst (CFA) and certified valuation analyst (CVA). As you move forward in your career, you may consider getting one of these other credentials, along with your CPA designation. Many people who work in these two fields have experience as CPAs.

Checking out the chartered financial analyst (CFA) credential

A *chartered financial analyst* (CFA) uses several skill sets to perform analysis on both companies and investment opportunities. You can find out details about the designation at www.cfainstitute.org. To obtain this credential, an individual must pass three exams, which are referred to as levels 1, 2, and 3. Here are some of the topics tested on the CFA exams:

- » **Quantitative methods:** Many of these concepts are taught in statistics classes, which you've likely taken if you've completed an undergraduate business or accounting degree. Quantitative methods include time value of money, probability, and other types of analysis.
- » **Economics:** This area includes the study of supply and demand, business cycles, inflation, and foreign currency exchange rates.
- » **Corporate finance:** Corporate finance goes over the decision-making process of raising capital and investing capital in a business.
- » **Portfolio management:** This area covers the concept of portfolio management and wealth planning. These areas refer to decisions about the types of investments a money manager selects. CFA exams cover many types of investments, including derivatives.



TIP

If you're more interested in analysis than generating financial statements, you may prefer working as a CFA.

Mulling over the certified valuation analyst (CVA) credential

A *valuation* places a dollar value on assets that may be difficult to value. A good example is an intangible asset, such as a patent, customer list, or trademark. A CVA takes a set of financial statements and performs additional work to compute company valuations.

A business may need to obtain a valuation in several circumstances. When a buyer and seller are negotiating the sale of a company, the parties may hire a CVA to compute the company's value. The price paid for the business may be very different from the *book value* of the assets, which is defined as assets minus liabilities.

Most industries have valuation benchmarks that drive the price paid for companies in that industry. Say, for example, that clothing manufacturers typically have a sale price based on three times the annual sales in dollars. In that case, the buyer and seller will compute three times sales and include that amount in their negotiation of a price for the company. CVAs explain and provide this type of analysis.

CVAs may also be involved when the value of a company must be determined in a legal matter. If two partners are in a legal dispute over their share of the company's value, a CVA may be retained to determine the value of the partnership.

You can find out more on the CVA designation at www.nacva.com.

Understanding the CPA Licensing Requirements

The Uniform CPA Examination is developed and graded by the American Institute of CPAs, or AICPA, which is the world's largest member association for the accounting profession. The AICPA exists to set accounting standards and to support and expand the accounting profession. You can find lots of great information at their website (www.aicpa.org).

The purpose of the CPA exam is to fulfill one of several requirements for a license to practice public accounting. Passing the exam qualifies you to be certified by a state. Although the exam is the same in every state, you obtain a license to practice from a State Board of Accountancy.

A *certified public accountant* is someone who has earned a license in their state. Check out www.thiswaytocpa.com to find out the requirements for your state. Each state has requirements that address three specific areas: education, experience, and ethics.

Going over education requirements

All states require a bachelor's degree to meet the education requirement, and the degree does not have to be in accounting. CPA candidates must also have 150 semester hours of college credit.

States added the extra hours to the education requirement because they feel that a bachelor's degree doesn't cover all the skills sets needed for the CPA profession. The accounting profession adds rules and regulations each year. These added requirements mean that the CPA candidate needs a larger body of knowledge. As technology becomes more complex, the CPA must learn more to use technology effectively.

Meeting the experience requirement

Most states require at least two years of experience in the accounting profession. The type of experience required also varies by state. In some cases, the work must be with a public accounting firm. Many firms will hire accountants who are not yet CPAs. These accountants work lower level accounting positions until they pass the CPA exam. At that point, they may be promoted into positions with more responsibility.



TIP

Some companies will help an employee pay for the CPA exam and a review course. Ask potential employers whether they offer this type of benefit.

Addressing ethics

State Boards view ethics as very important because CPAs have a great deal of responsibility. CPAs fill most of the senior accounting positions at companies. One primary responsibility is to generate financial statements. If an unethical CPA produces financial statements that are intentionally incorrect, the impact can be enormous.

Because the CPA's potential impact on stakeholders is so great, nearly all State Boards of Accountancy require an ethics exam, known as Rules of Professional Conduct. Many also require continuing education for CPAs in the field of ethics.

Walking through CPA Exam Topics

To pass the CPA exam, you must pass four exams. Here are the first three:

- » **Auditing and attestation (AUD):** This test covers the process of planning and implementing an audit. The test requires you to know a great deal of the language that's used to write audit opinions. Reviews, compilations, and other engagements are on the AUD test.
- » **Financial accounting and reporting (FAR):** The FAR test covers the nuts and bolts of working as an accountant. You need to know how to account for a variety of accounting transactions, including accrual entries. This test also covers financial-statement presentation.
- » **Regulation (REG):** REG covers many issues you may see in a business law class, including agency and sales law concepts. A large portion of the REG test addresses taxation of businesses, trusts, and estates as well as individual taxation.

CPA candidates choose the fourth exam based on their areas of interest and the work they prefer. Candidates choose one of three discipline exams: Business Analysis and Reporting, Information Systems and Controls, or Tax Compliance and Planning. Head over to Part 2 for more information on the discipline exams.