

Certified Financial Services Auditor Practice Exam (Sample)

Study Guide



Everything you need from our exam experts!

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SAMPLE

Questions

- 1. What does "unissued stock" refer to?**
 - A. The number of shares currently held by the public**
 - B. The number of shares that have not been sold**
 - C. The current price of a share**
 - D. The net worth of the company divided by outstanding shares**
- 2. Which type of securities is intended for resale within a short period of time?**
 - A. Investments held indefinitely**
 - B. Securities held for years**
 - C. Trading securities**
 - D. Long-term equity securities**
- 3. What investment restriction applies to Type II securities?**
 - A. Cannot be bought by corporations**
 - B. May invest only 10% of capital**
 - C. Must be held for longer than one year**
 - D. Must be cash equivalents**
- 4. Which of the following is NOT a type of bond?**
 - A. Corporate debt**
 - B. Preferred stock**
 - C. Municipal debt**
 - D. Money market debt**
- 5. How do bond prices typically react when interest rates go down?**
 - A. They decrease**
 - B. They remain stable**
 - C. They go up**
 - D. They fluctuate wildly**

- 6. Which type of asset includes receivables and short-term investments?**
- A. Current assets**
 - B. Fixed assets**
 - C. Intangible assets**
 - D. Equity assets**
- 7. Which term describes the complete automation of security transactions?**
- A. Comprehensive market strategy**
 - B. Continuous net settlement**
 - C. Automated compliance manager**
 - D. Efficient market execution**
- 8. What is a characteristic of an investor holding corporate bonds?**
- A. They have a say in management decisions**
 - B. They receive dividends regularly**
 - C. They do not have a say in management decisions**
 - D. They can convert bonds to stocks anytime**
- 9. What happens to warrants as the value of the stock appreciates?**
- A. They lose their market value**
 - B. They allow holders to purchase more stock**
 - C. They become worthless**
 - D. They are convertible into bonds**
- 10. What is the market condition when long-term debt sells at a premium?**
- A. When the stated rate is less than the market rate**
 - B. When the stated rate exceeds the market rate**
 - C. When the stated rate equals the market rate**
 - D. When interest rates are stable**

Answers

SAMPLE

- 1. B**
- 2. C**
- 3. B**
- 4. B**
- 5. C**
- 6. A**
- 7. B**
- 8. C**
- 9. B**
- 10. B**

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Explanations

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1. What does "unissued stock" refer to?

- A. The number of shares currently held by the public
- B. The number of shares that have not been sold**
- C. The current price of a share
- D. The net worth of the company divided by outstanding shares

Unissued stock refers to shares that a corporation has authorized but has not yet sold or distributed to shareholders. This can happen for several reasons, such as the company retaining shares for future use, like raising capital or employee compensation plans. By having a reserve of unissued stock, a company maintains flexibility in its financial planning and strategy. The other options do not accurately capture the definition of unissued stock. The number of shares currently held by the public pertains to outstanding stock, which is the opposite of unissued stock. The current price of a share refers to market valuation and does not concern the number of shares issued or unissued. Meanwhile, calculating the net worth of the company divided by outstanding shares pertains to determining earnings per share, which again, does not involve unissued stock. Understanding these distinctions helps clarify the concept and its relevance in financial audits and corporate finance.

2. Which type of securities is intended for resale within a short period of time?

- A. Investments held indefinitely
- B. Securities held for years
- C. Trading securities**
- D. Long-term equity securities

The correct choice, trading securities, refers to a specific category of financial instruments that are acquired by a business with the intent to sell them in the near term, usually to capitalize on short-term market gains. These securities are typically part of a trading portfolio and are actively bought and sold to take advantage of fluctuations in their market prices. Trading securities are recorded on the balance sheet at fair value, with any unrealized gains or losses recognized in earnings as they occur. This approach aligns with the strategy of short-term trading, where the aim is to benefit from immediate price movements rather than holding for long-term appreciation or income. In contrast, investments held indefinitely or securities held for years are typically classified as long-term investments, focusing on potential long-term capital growth or income through dividends rather than short-term market activities. Long-term equity securities, as well, are generally held with the expectation of longer-term governance and capital appreciation, which does not align with the objective of trading securities. This distinction is critical for understanding how different types of securities fit within financial strategies and the implications for valuation and reporting.

3. What investment restriction applies to Type II securities?

- A. Cannot be bought by corporations
- B. May invest only 10% of capital**
- C. Must be held for longer than one year
- D. Must be cash equivalents

Type II securities, often regarded within the context of investment restrictions, typically have specific guidelines associated with their purchasing and holding characteristics. The reason that an investment restriction allowing investment of only up to 10% of capital is accurate revolves around the inherent risk management framework established for such securities. This limit is designed to ensure that investors do not overly concentrate their portfolios in higher-risk securities, which can lead to significant volatility and potential capital loss. By restricting the investment to a maximum of 10% of capital, the regulation encourages a diversified portfolio. This is crucial because Type II securities may possess greater risk factors or lack sufficient liquidity, making it essential for investors to maintain balanced exposure across various asset types. Such a restriction ensures that while investors can engage in potentially lucrative opportunities presented by Type II securities, they do so in a manner that promotes overall financial stability and reduces risk exposure. Understanding this investment restriction is important as it influences how corporations, institutions, and individual investors devise their investment strategies to align with regulatory frameworks while pursuing growth opportunities.

4. Which of the following is NOT a type of bond?

- A. Corporate debt
- B. Preferred stock**
- C. Municipal debt
- D. Money market debt

Preferred stock is distinct from bonds as it represents an ownership stake in a company rather than a debt obligation. When investors purchase preferred stock, they are buying equity that typically provides dividends along with potential voting rights, depending on the class of stock. In contrast, bonds are loan agreements where the bondholder lends money to the issuer (such as a corporation or government) and receives periodic interest payments, as well as the return of the principal at maturity. Corporate debt, municipal debt, and money market debt all fall under the category of bonds or debt instruments. Corporate debt refers to bonds issued by companies to raise capital. Municipal debt represents bonds issued by local or state governments to fund public projects. Money market debt consists of short-term debt instruments that are generally considered very low risk, such as Treasury bills and commercial paper. Each of these options functions primarily as a means of borrowing, distinguishing them clearly from preferred stock.

5. How do bond prices typically react when interest rates go down?

- A. They decrease**
- B. They remain stable**
- C. They go up**
- D. They fluctuate wildly**

When interest rates decline, bond prices generally increase. This relationship is driven by the fixed nature of bond coupon payments. When new bonds are issued at a lower interest rate, existing bonds with higher coupons become more attractive to investors because they yield a higher return compared to newly issued bonds. As demand for these existing bonds rises, their prices go up in the marketplace. Moreover, when interest rates decrease, the present value of a bond's future cash flows (the coupon payments and the principal repayment at maturity) increases. This is due to the inverse relationship between interest rates and the present value of cash flows; lower interest rates make future cash flows worth more today, driving up the price of the bond. In summary, the dynamics of supply and demand, coupled with the present value calculations, lead to an increase in bond prices when interest rates fall. This reflects a fundamental principle in finance regarding the inverse relationship between interest rates and bond prices.

6. Which type of asset includes receivables and short-term investments?

- A. Current assets**
- B. Fixed assets**
- C. Intangible assets**
- D. Equity assets**

Current assets are a category of assets that are expected to be converted into cash or consumed within a year. Receivables, which represent amounts owed to the business by customers or clients, fall under this category because they are expected to be collected in the short term. Short-term investments also qualify as current assets since they can be easily liquidated or converted into cash within the same timeframe. This classification is critical for financial reporting and analysis, as it provides insights into a company's liquidity and short-term financial health. In contrast, fixed assets are long-term investments like property and equipment; intangible assets include non-physical items such as patents and trademarks; and equity assets are typically associated with ownership in a company, representing shareholders' interests. Understanding these distinctions helps in evaluating a company's financial statements accurately.

7. Which term describes the complete automation of security transactions?

- A. Comprehensive market strategy**
- B. Continuous net settlement**
- C. Automated compliance manager**
- D. Efficient market execution**

The term that best describes the complete automation of security transactions is continuous net settlement. This system facilitates the process by which transactions among market participants are settled automatically and regularly, thereby enhancing efficiency and reducing the need for manual input. Continuous net settlement achieves this by aggregating multiple transactions to minimize cash and security exchanges, significantly streamlining the overall settlement process. In addition, continuous net settlement helps reduce counterparty risk and enhances liquidity in the market, contributing to more systematic and efficient trade executions. As such, it supports a fully automated environment that aligns with the concept of completely automating security transactions. The other options do not specifically pertain to the complete automation of transactions in the same way. Comprehensive market strategy addresses broader market approaches rather than transaction automation. An automated compliance manager focuses on ensuring adherence to regulations and standards, while efficient market execution refers to the speed and effectiveness of transactions that occur but does not capture the automation aspect directly.

8. What is a characteristic of an investor holding corporate bonds?

- A. They have a say in management decisions**
- B. They receive dividends regularly**
- C. They do not have a say in management decisions**
- D. They can convert bonds to stocks anytime**

An investor holding corporate bonds is a creditor to the corporation, meaning they have lent money to the company in exchange for interest payments over time and the return of the principal amount upon maturity. This financial relationship inherently does not grant bondholders the right to participate in management decisions of the corporation. In contrast, stockholders are the ones who typically have voting rights and can influence management through their ability to vote on important corporate matters like board of director elections. Additionally, while bondholders do receive interest payments, these are not considered dividends; dividends are specific to equity shareholders. Bonds also cannot be converted to stocks unless they are specifically classified as convertible bonds, and investors do not receive regular dividends from bonds as they would from stocks. Thus, the characteristic that correctly describes an investor holding corporate bonds is that they do not have a say in management decisions.

9. What happens to warrants as the value of the stock appreciates?

- A. They lose their market value**
- B. They allow holders to purchase more stock**
- C. They become worthless**
- D. They are convertible into bonds**

When the value of the stock appreciates, warrants become more valuable because they provide the holder the right to purchase the underlying stock at a predetermined price, known as the exercise or strike price. As the market price of the stock increases above the strike price of the warrant, the potential for profit increases. This incentivizes holders to exercise their warrants before expiration, as they can buy the stock at the lower strike price and potentially sell it at the higher market price. Warrants are often seen as a leverage mechanism: if the stock price rises significantly, the gains from exercising the warrant can be much larger than the initial investment in the warrant itself. Thus, as the stock's value appreciates, warrants typically gain market value rather than lose it or become worthless, and they remain distinct financial instruments for stock acquisition rather than being convertible into bonds.

10. What is the market condition when long-term debt sells at a premium?

- A. When the stated rate is less than the market rate**
- B. When the stated rate exceeds the market rate**
- C. When the stated rate equals the market rate**
- D. When interest rates are stable**

When long-term debt sells at a premium, it indicates that the stated interest rate on the debt exceeds the market interest rate. This situation arises because investors are willing to pay more for a bond or debt instrument that offers a higher return, reflected in the stated interest rate, compared to what is currently available in the market. When the stated rate is higher, investors perceive the bonds as more valuable since they provide more favorable cash flows than new issuances, which may pay lower interest due to changes in market conditions. Therefore, the price of these bonds will rise until the yield, or effective interest returned to investors, aligns with prevailing market rates. In contrast, if the stated rate were less than the market rate, the demand for that debt would decrease, resulting in a discount price. Similarly, if the rates were equal, the debt would typically be valued at par. Stability in interest rates does not directly dictate the premium or discount status of bonds; rather, it pertains more to the relationship between the stated and prevailing market rates.