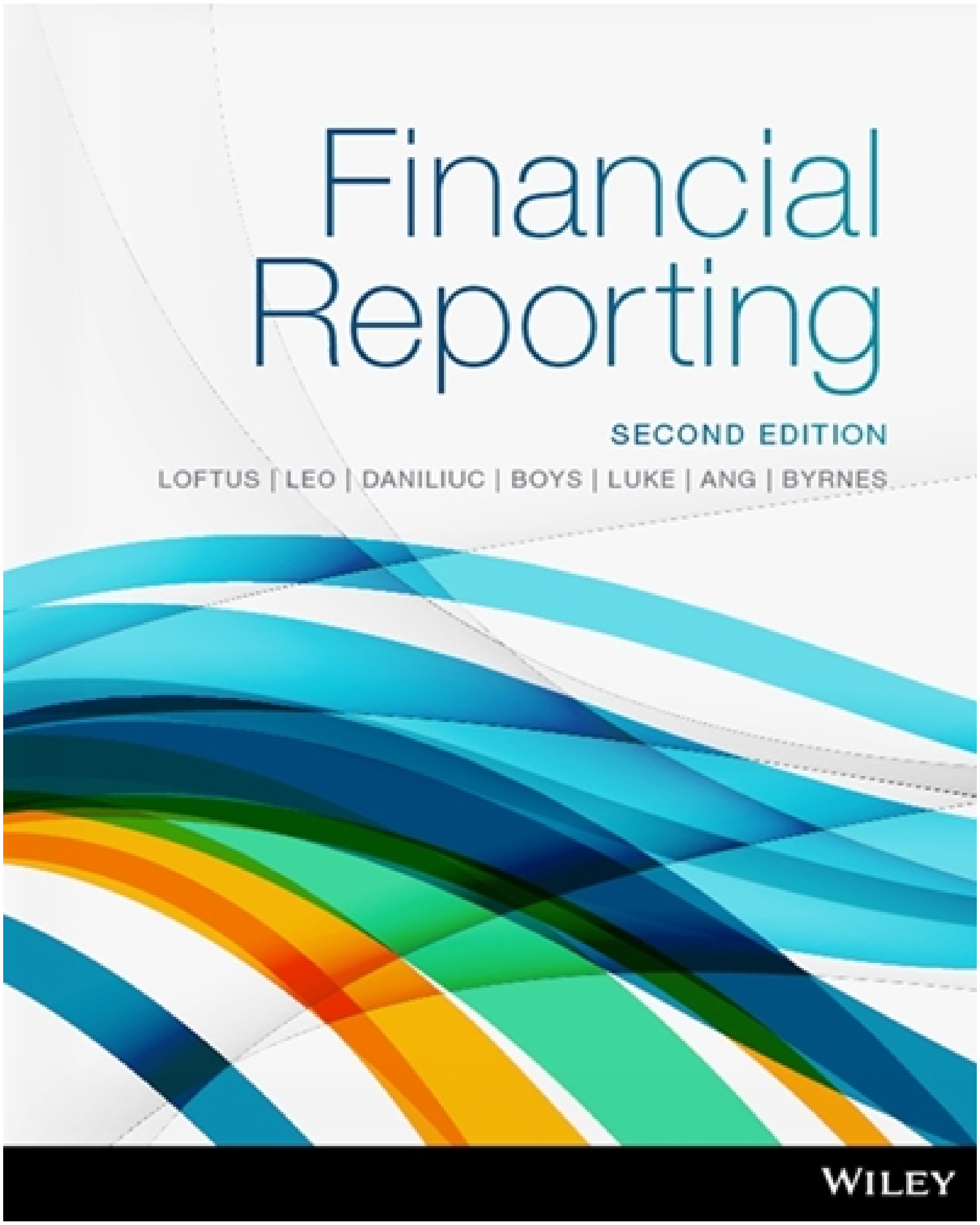
Test Bank for Financial Reporting 2nd Edition by Loftus



Test Bank

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to accompany

Financial reporting

2nd edition

by
Loftus et al.

WILEY

Chapter 2: Application of accounting theory

Multiple choice questions

1. In which of the following contexts would accountants be required to exercise professional judgement?

a. Deciding whether property, plant and equipment should be measured at fair value after its initial recognition.
b. Determining the most appropriate depreciation method to be used for non-current assets.
c. Measuring the net realisable value of inventories.
*d. All of the options are correct.

Answer: d
Learning objective 2.1: describe the role of professional judgement in the preparation of financial reports.

2. Considering whether a past event has arisen relates to which of the following components in accounting policy decisions:

*a. Definition.
b. Recognition.
c. Measurement.
d. Disclosure.

Answer: a
Learning objective 2.2: identify the major decision areas in considering policies to account for transactions and other events.

3. Positive theories:

a. explain why managers choose a particular accounting method.
b. might be descriptive of accounting practice.
*c. All of these options are correct.
d. rely on real-world observations.

Answer: c
Learning objective 2.3: explain how normative and positive theories are used in accounting.

4. Normative theories are developed using the following process:

a. Principles → Assumptions → Objectives → Definitions/Actions.
b. Objectives → Definitions/Actions → Assumptions → Principles.
c. Definitions/Actions → Principles → Assumptions → Objectives.
*d. Objectives → Assumptions → Principles → Definitions/Actions.

Answer: d
Learning objective 2.3: explain how normative and positive theories are used in accounting.

5. Marcus observes that the bank overdraft account is a liability account and has a credit balance. He also notices that the accounts payable account is a liability account and has a credit balance. Therefore, Marcus comes to the conclusion that all liability accounts have a credit balance. Which approach is Marcus using in developing his theory that all liability accounts having credit balances?

a. Conceptual reasoning.
b. Conclusive reasoning.
*c. Inductive reasoning.
d. Deductive reasoning.

Answer: c
Learning objective 2.3: explain how normative and positive theories are used in accounting.

6. A limitation of the use of inductive reasoning in the development of an accounting theory is that it:

*a. does not question the appropriateness of the observed actions.
b. attempts to improve a particular process.
c. is based on identifying a set of objectives.
d. is only useful for developing normative theories.

Answer: a
Learning objective 2.3: explain how normative and positive theories are used in accounting.

7. Which of the following statements is correct?

a. Accounting is only concerned with recording transactions and does not require professional judgement.
b. Normative theories tend to maintain *the status quo*.
*c. The process of deductive reasoning starts with objective setting.
d. The conceptual framework is developed through an inductive approach.

Answer: c
Learning objective 2.3: explain how normative and positive theories are used in accounting.

8. Positive accounting theory is based on an economic assumption that all individuals act in their own self-interest and are wealth maximisers. This economic assumption is referred to as the:

a. responsible economic person assumption.
b. logical economic person assumption.
*c. rational economic person assumption.
d. reasonable economic person assumption.

Answer: c
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

9. Which of the following is *not* a relationship focused on by positive accounting theory?

a. debt contracts.
b. political contracts.
c. managerial contracts.
*d. creditor contracts.

Answer: d
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

10. Which of the following statements is *not* consistent with agency theory?

a. Managers are employed to conduct business on behalf of the shareholders.
b. Managers have a legal and fiduciary duty to act in the best interests of the shareholders.
*c. Managers are more likely to favour the interests of lenders in managing debt contracts.
d. Costs are incurred in monitoring and controlling agent's behaviour.

Answer: c
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

11. An example of monitoring costs is:

*a. implementing a management remuneration plan.
b. preparing quarterly financial statements for lenders.
c. linking management incentives to entity performance.
d. measuring the residual loss of the manager purchasing office supplies for his/her own personal use.

Answer: a
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

12. The majority of monitoring and bonding costs will be borne by:

a. shareholders.
b. creditors.
*c. agents.
d. principals.

Answer: c
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

13. Residual loss, as an agency cost, refers to:

a. the costs incurred by the agent when implementing assurances that they are acting in the principal's best interests.
b. the costs incurred by the principal in observing, evaluating and controlling the agent's behaviour.
c. the amount by which the marginal cost is less than the expected benefit of additional monitoring and bonding.
*d. the amount by which the marginal cost exceeds the expected benefit of additional monitoring and bonding.

Answer: d
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

14. Positive accounting theory suggests that the separation of ownership and control within an entity means managers, as agents, are likely to act:

*a. in their own interests.
b. in the interests of the debtholders.
c. in the interests of the shareholders.
d. in the interests of the directors.

Answer: a
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

15. Which of the following is *not* identified as one of the major problems that can arise in owner-manager agency relationships?

a. Risk aversion.
b. Dividend retention.
*c. Reduced incentives.
d. Horizon problems.

Answer: c
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

16. In an owner–manager agency relationship the problem of risk aversion arises because:

a. shareholders prefer the managers to take fewer risks in order to maximise the returns on their investment.
*b. managers prefer to make decisions that are less risky for the entity as they have more to lose than the shareholders.
c. managers have less capital invested in the entity than shareholders.
d. shareholders generally have no other sources of income.

Answer: b
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

17. An agreement between managers and lenders to maintain a minimum ratio of working capital can assist which of the following problems in relation to increased lender's risk?

a. claim dilution.
b. asset substitution.
c. underinvestment.
*d. excessive dividend payments.

Answer: d
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

18. Claim dilution arises when:

a. the entity is unable to repay a loan.
b. a lender restricts an entity from obtaining debt of a lower priority.
*c. the entity takes out a secured loan after obtaining an unsecured loan from another lender.
d. a lender restricts an entity from obtaining debt with an earlier maturity date.

Answer: c
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

19. The problem of ‘underinvestment’ occurs when managers are reluctant to undertake projects with positive net present value because:

a. shareholders prefer less risk than do lenders and managers.
*b. the increased funds obtained from the projects will rank higher in priority of payments to creditors over shareholders in the event of the entity being liquidated.
c. the projects would result in a reduction of managers’ incentives.
d. managers prefer to maintain a high level of funds within the entity.

Answer: b
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

20. The following statements about asset substitution are true *except for*:

a. Managers have incentives to use debt finance to invest in higher-risk assets with the expectation of obtaining higher returns for shareholders.
*b. Lenders are willing to share higher returns earned when managers invest in higher-risk projects.
c. A debt covenant that restricts investment opportunities of the entity can reduce the entity’s borrowing costs.
d. Asset substitution arises when an entity uses borrowed funds to invest in higher risk assets than those agreed upon in the debt contract.

Answer: b
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

21. An example of political costs is:

a. lower taxes on mining companies.
*b. economic sanctions imposed on retailers who purchase their supplies from overseas businesses that use child labour.
c. excessive consumption of perquisites.
d. having a debt covenant.

Answer: b
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

22. Under the debt hypothesis for accounting policy choice:

a. managers act in their own interests and therefore prefer more remuneration.
b. managers of entities with bonus plans prefer accounting policies that increase profit in the long-term.
c. managers have no discretion in choosing accounting policies relating to debt.
*d. managers of entities with high leverage are likely to choose accounting policies that increase profit and equity.

Answer: d
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

23. Which of the following statements is true with regards to the political cost hypothesis?

a. Political costs arise as a result of an entity's relationships with shareholders and lenders.
b. Managers of financial institutions may prefer to increase profits to reduce government pressure to pass on interest rate cuts.
c. Smaller entities are more likely to be the target of environmental groups.
*d. Managers of entities that are more politically visible are expected to choose accounting policies that reduce profit in order to avoid political costs.

Answer: d
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

24. The horizon problem in owner-manager agency relationships can be reduced by:

a. paying a bonus linked to the dividend pay-out ratio.
b. encouraging managers to invest in higher risk projects.
c. linking management's bonus to profits.
*d. aligning manager's interests with the longer-term interests of shareholders through share-based remuneration schemes.

Answer: d
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

25. Which of the following is *not* an example of a debt covenant?

a. a maximum leverage ratio of 70%.
*b. a maximum interest cover of 2.5 times.
c. a restriction in the amount of dividends distributed as a percentage of profit.
d. a restriction in undertaking mergers and takeovers unless approved by the lender.

Answer: b
Learning objective 2.4: explain the implications of positive accounting theory for accounting policy choice.

26. Which of the following statements about the efficient-market hypothesis is *not* correct?

a. Security prices in an efficient market rapidly respond to new information.
b. Investors in an efficient-market are unable to earn returns greater than those commensurate with the level of risk.
*c. Good news of an entity's future prospects would lead to a decrease in demand for the entity's shares.
d. Increased demand for shares will lead to an increase in the share price.

Answer: c
Learning objective 2.5: compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting.

27. The mechanistic hypothesis of capital markets means that:

*a. investors are assumed to ignore differences in accounting policies when analysing financial statements.
b. investors are not easily fooled by changes in the depreciation rates.
c. investors respond differently to increases in profit when they result from cash flow implications as opposed to non-cash flow implications.
d. available information can be used to earn returns beyond those that compensate for the risk involved.

Answer: a
Learning objective 2.5: compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting.

28. Which of the following statements about the strong form of market efficiency is *not* correct?

a. Security prices fully reflect all information, including that which is not publicly available.
*b. Investors are able to participate in 'insider trading'.
c. Investors are unable to earn abnormal returns through private information.
d. Capital markets are not considered to be efficient in the strong form.

Answer: b
Learning objective 2.5: compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting.

29. A weak form of market efficiency implies that:

a. investors would be able to earn abnormal returns by using publicly available information.
*b. a security's price at a particular time fully reflects the information contained in its sequence of past prices.
c. investors would be unable to earn abnormal returns by trading on private information.
d. a security's price at a particular time fully reflects both publicly and privately available information.

Answer: b
Learning objective 2.5: compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting.

30. The most relevant form of market efficiency to financial reporting is:

a. the weak form.
*b. the semi-strong form.
c. the strong form.
d. None of the options is correct.

Answer: b
Learning objective 2.5: compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting.