Testbank

to accompany

Financial Reporting

by

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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) Determining depreciation method used for non-current assets.
b) Estimating net realisable value of inventories.
c) Deciding which model to use to measure value of property, plant and equipment after initial recognition.
*d) All of the options are correct.

Answer: d
Learning Objective 1: describe the role of professional judgement in the preparation of financial reports

2) Considering whether to use historical cost or fair value relates to which of the following components in accounting policy decisions:

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

Answer: c
Learning Objective 2: Identify the major decision areas in considering policies to account for transactions

3) Normative theories:

*a) prescribe what should be the case based on a specific objective.
b) are based on what is happening in the world.
c) explain why people behave in certain ways.
d) predicts unobserved phenomena.

Answer: a
Learning Objective 3: Explain how normative and positive theories are used in accounting

4) Which of the following processes describe how positive theories are developed:

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: c
Learning Objective 3: Explain how normative and positive theories are used in accounting

5) Sally observes that the cash account is an asset account and has a debit balance. She also notices that inventories account is an asset account and has a debit balance. Therefore, Sally comes into conclusion that all asset accounts have a debit balance. Which approach does Sally use in developing her theory about all asset accounts having a debit balance?

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

Answer: b
Learning Objective 3: Explain how normative and positive theories are used in accounting

6) Which of the following is a limitation of the use of inductive reasoning in the development of theory:

*a) it does not attempt to improve current practices.
b) it is based on the subjective selection of objectives by the theorist.
c) it is not based on observed actions.
d) it is only useful for developing prescriptive theories.

Answer: a
Learning Objective 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 involve human behaviours.
b) Positive theories provide recommendations about what should happen.
c) Inductive reasoning starts with objective setting.
*d) The conceptual framework is developed through a deductive approach.

Answer: d
Learning Objective 3: Explain how normative and positive theories are used in accounting

8) An economic assumption which assumes that all individuals act in their own self-interest and are wealth maximisers is called:

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

Answer: a
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

9) Political contracts refer to the relationship between an entity and the following parties, except:

a) government.
b) lobby groups.
c) trade unions.
*d) creditors.

Answer: d
Learning Objective 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) Entities employ managers to conduct business on their behalf and to negotiate contracts with other parties.
*b) Managers are more likely to favour the interests of debtholders than those of shareholders in managing debt contracts.
c) Managers will not always act in the best interest of shareholders.
d) There are costs incurred in order to control agent's behaviour.

Answer: b
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

11) An example of bonding costs is:

a) auditor's fees.
b) cost of implementing a management remuneration plan.
*c) cost of preparing quarterly financial reports.
d) cost of setting up company's code of conducts.

Answer: c
Learning Objective 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) principals.
*b) agents.
c) shareholders.
d) creditors.

Answer: b
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

13) Which of the following contractual relationships is not the focus of positive accounting theory:

a) Shareholder – manager relationships.
b) Manager – lender relationships.
*c) Shareholder – lender relationships.
d) Political relationships.

Answer: c
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

14) The most correct reason of why residual loss is incurred is:

a) principals do not take any actions to control agents' behaviours.
b) agents do not always act in the best interest of principals.
*c) it is too costly for principals to completely monitor agents' behaviours.
d) agents are rational wealth maximisers.

Answer: c
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

15) Which of the following problems arises within owner-manager agency relationships:

I.	Risk aversion	III.	Claim dilution
II.	Asset substitution	IV.	Dividend retention

a) I and III.
*b) I and IV.
c) II and III.
d) II and IV.

Answer: b
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

16) The risk aversion problem in shareholder–manager agency relationships arises because:

*a) managers are more risk-averse than shareholders.
b) shareholders prefer less risk than do managers.
c) managers have less capital invested in the entity than shareholders.
d) shareholders are not able to diversify their risk.

Answer: a
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

17) The way that lenders charge a higher interest rate for loans assessed to be of higher risk is known as:

a) risk aversion.
b) wealth maximisation.
c) claim dilution.
*d) price protection.

Answer: d
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

18) Debt covenants:

a) contain restrictions to control lenders' activities.
b) are designed to protect the interest of managers.
*c) reduce the risk to lenders.
d) result in higher interest rates being imposed on the borrowers.

Answer: c
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

19) The problem of 'underinvestment' occurs when the entity faces financial difficulty and managers are reluctant to undertaken projects with positive net present value because:

a) managers prefer less risk than do lenders.
*b) the projects lead to increased funds available to lenders rather than shareholders.
c) the projects would adversely affect managers' bonus payments.
d) managers prefer to maintain a greater level of funds within the entity.

Answer: b
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

20) Which of the following statements about asset substitution is incorrect:

a) Managers have incentives to use debt finance to invest in higher-risk assets.
*b) When managers invest in higher-risk projects, lenders would share higher returns earned from the projects.
c) The problem of asset substitution can be reduced by having a debt covenant that restricts investment opportunities of the entity.
d) Asset substitution increased the risk borne by lenders.

Answer: b
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

21) An example of political costs is:

*a) higher tax imposed on mining companies.
b) cost of implementing sound corporate governance arrangements.
c) having a debt covenant.
d) excessive consumption of perquisites.

Answer: a
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

22) Under the debt hypothesis:

a) managers prefer to have more remuneration.
b) managers' interests are more aligned with those of lenders than with those of shareholders.
*c) managers of entities with high leverage are likely to choose accounting policies that increase profit and equity.
d) managers do not have discretion in choosing accounting policies.

Answer: c
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

23) Which of the following statements apply to the political cost hypothesis:

a) Political costs arise as a result of an entity's relationships with shareholders and lenders.
b) Managers would prefer accounting policies that increase profit in order to compensate for political costs.
c) Smaller entities are more likely to be the target of lobby groups.
*d) Managers of larger entities are more likely to choose accounting policies that reduce profit in order to avoid political costs.

Answer: d
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

24) Which of the following statements about the mechanistic hypothesis is not correct:

a) investors can be misled by the use of different accounting policy choices.
*b) investors respond differently to changes in profit depending on what causes the changes.
c) investors ignore differences in accounting policies when analysing financial statements.
d) investors are only concerned about changes in reported figures in financial statements.

Answer: b
Learning Objective 5: Compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting

25) A market is efficient if:

a) investors are able to earn profits by trading on information.
b) it adjusts steadily to new information.
*c) share prices fully reflect available information about the shares.
d) available information can be used to earn returns beyond those that compensate for the risk involved.

Answer: c
Learning Objective 5: Compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting

26) Which of the following statements about the semi-strong form of market efficiency is not correct:

*a) Share prices would adjust more rapidly to information presented in financial statements than in the notes.
b) All information is assumed to be available free of cost to all market participants.
c) There are no differences in the assessment of the implications of new information for the valuation of shares.
d) Transaction costs in trading securities are assumed to be nil.

Answer: a
Learning Objective 5: Compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting

27) When market is efficient in the semi-strong form:

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 able 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: c
Learning Objective 5: Compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting

28) Which form of market efficiency is the most relevant to financial reporting:

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

Answer: b
Learning Objective 5: Compare the implications of the mechanistic hypothesis and the efficient market hypothesis for financial reporting

29) The horizon problem in owner-manager agency relationships can be reduced by:

a) paying a bonus linked to the dividend pay-out ratio.
b) having financial statements audited.
c) linking management's bonus to profits.
*d) paying a portion of managerial remuneration as shares.

Answer: d
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice

30) Which of the following is not an example of debt covenant:

a) a restriction in the amount of dividends distributed as a percentage of profit.
*b) a maximum interest cover of 2.5 times.
c) a restriction in undertaking mergers and takeovers unless approved by the lender.
d) a maximum leverage ratio of 60%re.

Answer: b
Learning Objective 4: Explain the implications of positive accounting theory for accounting policy choice