

Test Bank

to accompany

Accounting Theory

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PREPARED BY

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<p>CHAPTER 1 Introduction</p>



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Chapter 1: Introduction

True/False

1. The main purpose of accounting theory is to prescribe accounting rules for practitioners.

- a. True
- *b. False

Feedback: The main purpose of accounting theory is to explain current accounting practice and to provide the basis for development of such practice.
Section "Overview of accounting theory"

2. As a result of accounting prescription being developed in a haphazard way there are follow-on inconsistencies in practice.

- *a. True
- b. False

Feedback: Because of the haphazard development of prescriptive accounting practice the theories underlying the practice have developed in an unstructured manner resulting in inconsistent practices eg. different measurement methods for different classes of assets.
Section "Overview of accounting theory"

3. An example of an inconsistency in accounting practice is for a company to depreciate some of its assets using the straight-line method and some using the reducing-balance method.

- a. True
- *b. False

Feedback: This is not an example of an inconsistency in accounting practice but a choice available so that the amount of depreciation charged best reflects the way in which the asset contributes to the earning of revenue.
Section "Overview of accounting theory"

4. No systemic theory of accounting was devised from the time of Pacioli in the 15th century until the opening of the 19th century.

- *a. True
- b. False

Feedback: For 300 years following Pacioli's 1494 treatise, progress in accounting concentrated on refining practice rather than on developing theory.
Section "Overview of accounting theory"

5. The period 1800 - 1955 has been labelled the empirical period in accounting development.

- *a. True
- b. False

Feedback: The period 1800 -1955 has been labelled the empirical period in accounting development. The emphasis was on real-world observation to explain why accountants account as they do.
Section "Overview of accounting theory"

6. The development of a conceptual framework has solved the problem of inconsistency in the application of accounting in practice.

- a. True
- *b. False

Feedback: Because conceptual frameworks seek to provide universal guidance they have proved too general to provide a clear set of guidelines which totally resolve inconsistencies in accounting practice.
Section "Overview of accounting theory"

7. During the normative period of accounting theory development, theorists were concerned with explaining and understanding current accounting practice.

- a. True
- *b. False

Feedback: During the normative period theorists were more concerned with developing theories about what accounting practitioners ought to be doing rather than what practitioners were actually doing.
Section "Overview of accounting theory"

8. The normative period of accounting theory ended because empirical testing proved the theories developed during this period to be false.

- a. True
- *b. False

Feedback: In fact, one of the reasons that the normative period drew to a close was the lack of testing methods available for the theories.
Section "Overview of accounting theory"

9. The 'debt hypothesis' predicts that the larger the firm's debt to equity ratio, the more likely it is that the firm's manager will select accounting procedures that shift reported profits from future periods to current periods - this is to reduce the likelihood of the firm technically breaching its debt covenants. The theory underlying this hypothesis would be a positive theory.

- *a. True
- b. False

Feedback: The objective of positive accounting theory is to explain and predict accounting practice. A normative theory, which this is not, would prescribe what the accountants ought to do as the firm's debt covenants come close to a technical breach.
Section "Overview of accounting theory"

10. An example of a positive accounting theory is the bonus plan hypothesis. This predicts that managers who are not remunerated via bonus plans use profit-increasing accounting methods more than managers who are remunerated via bonus plan.

- a. True
- *b. False

Feedback: It is the other way around. According to bonus plan hypothesis, managers who *are* remunerated via bonus plans use profit-increasing accounting methods more than those who are not remunerated via bonus plans in order to maximise profits in the accounting period when they are likely to receive bonuses.
Section "Overview of accounting theory"

11. Behavioural research, which is concerned with the broader sociological implications of accounting numbers and the associated actions of 'key players' as they react to accounting information, was first used in an accounting context in the 1980s.

- a. True
- *b. False

Feedback: While the definition of behavioural research provided in the statement is correct, behavioural research in accounting started in the 1950s not the 1980's.
Section "Overview of accounting theory"

12. While the accounting profession has sought to use accounting theories to unify accounting practice and make it more useful, academics use accounting theories to understand the role and impact of accounting information. Therefore, academic research on accounting is not useful for professional practice.

- a. True
- *b. False

Feedback: While the statement about the differing priorities of academics and professionals is true, it is not true to state that academic research is not useful for professional practice. Standard setters and other accounting professionals can use the output of positive research, e.g. the impact that a new statement will have on accounting practice, to refine the development of accounting prescriptions.

Section "Overview of accounting theory"

13. The ultimate objective of international accounting standards is to make all countries use the same standards so that there are no differences in reported information across international reporting boundaries.

- a. True
- *b. False

Feedback: Even if every country adopted international accounting standards outright there will always be differences in the way firms report the same information as accounting standards cannot fully remove the element of choice that will always exist within those standards.
Section "Overview of accounting theory"

14. The current Australian conceptual framework consists of SAC 1, SAC 2, SAC 3, and SAC 4.

- a. True
- *b. False

Feedback: SAC 3 and SAC 4 have been replaced by the International Accounting Standard Board's (IASB) conceptual framework. Therefore the current Australian conceptual framework consists of SAC 1, SAC 2, and the IASB's conceptual framework.
Section "Overview of accounting theory"

Multiple choice

15. The statement that best defines what is meant by a theory is:

- a. A coherent set of hypothetical, conceptual and pragmatic principles forming the general framework for a field of inquiry
- b. A deductive system of statements of decreasing generality
- c. A set of ideas used to explain real-world observations
- *d. All of the above

Feedback: As stated in the text, the term 'theory' can be used in different ways. Answers a., b. & c. are all accepted definitions of the term theory.
Section "Overview of accounting theory".

16. Which of these characteristics is the least important for an accounting theory to be considered acceptable?

- a. How well the accounting theory has been constructed
- b. How acceptable the implications of the accounting theory are
- *c. How prescriptive the accounting theory is in relation to accounting practice
- d. How well the accounting theory explains and predicts reality

Feedback: An acceptable theory does not have to be prescriptive. In other words, it does not have to state what ought to be, it is sufficient for an acceptable theory to explain and predict reality.
Section "Overview of accounting theory".

17. The statement that best defines the term 'empirical analysis' is:

- a. Reasoning from the general to specific statements
- b. Testing the truth of a proposition by observing a subset of real world observations or events
- *c. Understanding practices, activities or behaviour based upon direct observations and/or experience
- d. Actions undertaken by interested parties to influence the actions or outcomes of decisions made by others

Feedback: Answer a. is the definition of 'deduction', answer b. is the definition of 'induction', answer d. is the definition of 'lobbying'.
Section "Overview of accounting theory".

18. Which of these is an era of accounting theory development during which the emphasis was on providing an overall framework to explain and develop accounting practice by using the empirical analysis method?

- *a. The general scientific period
- b. The pre-scientific period
- c. The practical approach period
- d. The normative period

Feedback: The period 1800 - 1955 is often referred to as the 'general scientific period'. Its emphasis was on providing an overall framework to explain why accountants account as they do using real world observations.

Section "Overview of accounting theory".

19. The rapid increase in demand for both management accounting and financial accounting information in the 1800s can be explained by:

- a. The rapid development of technology during this time
- b. The 'birth' of the corporation
- c. Increasing separation of business management from ownership
- *d. All of the above

Feedback: All of the factors described in a., b. & c. contributed to the rapid rise in the demand for management and financial accounting information.

Section "Overview of accounting theory".

20. Which of these would be an example of normative research (research based upon a normative theory)?

- a. A researcher, through observation, documents the breeding cycle of the gnat
- b. An economist develops a method of using last month's share market prices to predict unemployment levels
- *c. In order to ensure consistency in schooling outcomes an education researcher recommends that all final year school students undertake the same six subjects for assessment purposes
- d. An accounting researcher predicts that auditors will perform faster audits when the audit materials are presented in graphical rather than tabular form

Feedback: This is the only situation that is prescriptive - the researcher is stating that consistency in education outcomes is paramount and prescribing a practice that he/she believes will achieve this outcome.

Section "Overview of accounting theory".

21. The major focus of the normative accounting theories during the period 1956 - 1970 was:

- a. Refining accounting practices
- *b. The impact of changing prices on the value of assets and the calculation of profit
- c. Providing explanations of accounting practices
- d. The broader sociological implications of accounting numbers

Feedback: A is the focus of accounting developments during the pre-theory period; C is the focus of positive accounting theories; D is the focus of behavioural research.

Section "Overview of accounting theory".

22. The two groups that dominated the normative period of accounting theory development were:

- a. The proponents of historical cost accounting and the conceptual framework proponents
- b. The critics of historical cost accounting and the conceptual framework opponents
- c. The proponents of historical cost accounting and the conceptual framework opponents
- *d. The critics of historical cost accounting and the conceptual framework proponents

Feedback: The critics of historical cost accounting and the conceptual framework proponents dominated the normative period.

Section "Overview of accounting theory".

23. Which of these is one of the two main factors that prompted the demise of the normative period of accounting research?

- *a. The availability of financial economic principles and testing methods
- b. Severe criticisms from positive accounting theorists
- c. The resurgence of behavioural research
- d. The increased popularity of a conceptual framework

Feedback: The two main factors that prompted the demise of normative period were (1) the unlikelihood of acceptance of any particular normative theory and (2) the availability of financial economic principles and testing methods.

Section "Overview of accounting theory".

24. Which of the following arguments are reasons why normative theories cannot be empirically tested?

- i. It is impossible to demonstrate empirically what ought to be
- ii. Normative theories are based on value judgements
- iii. There is no access to empirical data sets

- a. i, iii
- *b. i, ii
- c. ii, iii
- d. i, ii, iii

Feedback: The criticisms of normative theories outlined in the text include i and, ii. Despite the increased access to empirical data sets, it is still difficult to test normative theories as they are based on subjective opinions of how accounting should be practiced and therefore it is impossible to obtain general acceptance of any particular normative accounting theory. Section "Overview of accounting theory".

25. Behavioural accounting research is concerned with the broader sociological implications of accounting numbers. As such it is mainly concerned with the reactions of which of the following groups to accounting numbers?

- a. Auditors and managers
- b. Shareholders and government
- c. Creditors
- *d. All of the above

Feedback: Behavioural accounting research can investigate the effects of accounting numbers on any individuals or groups who are potentially affected by those numbers. Section "Overview of accounting theory".

26. In which of the following situations would you probably not apply a behavioural theory if you wanted to undertake accounting research?

- a. You want to know whether investors use disclosures when deciding whether to invest in a firm
- *b. You are interested in understanding the effect of unexpected earnings announcements by firms on share prices
- c. You want to know what factors loan managers consider when assessing the riskiness of a new client firm
- d. You want to determine whether individuals are quicker at analysing financial information using graphs or tables

Feedback: This situation involves capital markets research as it is concerned with the effects of accounting numbers at the aggregate level.

Section "Overview of accounting theory".

27. The statement that best describes the interaction of academic and professional research interests with respect to accounting theory, is:

- a. Academic and professional research interests are incompatible as academic research centres on positive theories which are not prescriptive
- b. Academic researchers use positive accounting theories whereas the accounting profession uses normative theories
- *c. While accounting profession researchers seek normative (prescriptive) theories for accounting practice, these theories are not incompatible with academic (positive) theories which can be used to advise accounting professionals in the development of prescriptive practices
- d. None of the above

Feedback: Standard setters and other accounting professionals can use the output of positive research, e.g. the impact that a new standard will have on accounting practice, to refine the development of accounting prescriptions.

Section "Overview of accounting theory".

28. Which of the following is not regarded as a period of accounting theory development?

- a. The normative period
- *b. The pre-scientific period
- c. The positive accounting theory period
- d. The mixed development period

Feedback: The 'pre-scientific' period does not feature - all other periods do feature.

Section "Overview of accounting theory".

29. Select the pair of periods of accounting theoretical development that are based on a similar approach.

- *a. The general scientific and the positive periods
- b. The normative and positive periods
- c. The general scientific and the normative periods
- d. None of the above

Feedback: The general scientific and the positive periods of accounting theoretical development are both based on an empirical approach.

Section "Overview of accounting theory".

30. The statement that is not descriptive of positive theories is,

- a. They are descriptive rather than prescriptive
- b. They avoid making value-laden judgements
- c. They explain why people behave in a certain manner
- *d. Their primary concern is developing policy recommendations for accounting practice

Feedback: This statement is descriptive of normative accounting theories not positive theories.

Section "Overview of accounting theory".

31. The research question that is most unlikely to be tested using positive methodology is:

- a. Which firms are more likely to use straight-line depreciation rather than diminishing-balance depreciation?
- *b. Is the quantitative data derived from given sets of operations, based on an overall accounting theory, useful to users of financial statements?
- c. How do changes in tax rules affect a firm's leverage position?
- d. Are firms with more intangible assets more likely to repurchase their shares?

Feedback: A, C, and D are examples of research questions covered by positive accounting theory because they attempt to explain and describe the reasons for current accounting practices. B is a typical question under normative theory (decision-usefulness approach) as it concerns the usefulness of accounting data.

Section "Overview of accounting theory".

Essay Questions

32. "Many accounting prescriptions on how to account were developed to resolve problems as they arose., hence the theory underlying those prescriptions also developed in a largely unstructured manner. This has led to inconsistencies in practice". J. Godfrey, et el, 'Accounting Theory', 7th Ed. p.5. Discuss the quotation, including in your discussion at least three examples of inconsistencies in accounting practice.

33. Give a brief overview of the development of accounting theory in:

- the pragmatic period (1800-1955)
- the normative period (1956-1970)
- the positive period (1970's-2000)

34. Compare and contrast the normative approach to accounting theory with the positive approach.

35. 'The positive and normative approaches to accounting theory are not incompatible.' Explain and discuss.