

Chapter 1—AN INTRODUCTION TO ACCOUNTING THEORY

TRUE/FALSE QUESTIONS

1. Financial accounting refers to accounting information that is used by management for decision-making purposes.

ANSWER: False

2. Accounting theory includes the basic rules, definitions, and principles that underlie the drafting of accounting standards and how they are derived.

ANSWER: True

3. Accounting theory includes conceptual frameworks, accounting legislation, valuation models, and hypotheses and theories.

ANSWER: True

4. Hypotheses and theories are based on an informal method of investigation.

ANSWER: False

5. Replacement cost as a measure of asset value is generally more reliable than historical cost.

ANSWER: False

6. Accounting theory is developed and refined by the process of accounting research.

ANSWER: True

7. Indirect measures are usually preferable to direct measures because they are less costly to obtain.

ANSWER: False

8. Assessment measures are concerned with particular attributes of objects and are always direct measurements.

ANSWER: False

9. When a direct assessment measure is used, there is always only one correct measure.

ANSWER: False

10. The simplest type of measuring system is the nominal scale.

ANSWER: True

11. A chart of accounts is an example of an ordinal classification.

ANSWER: False

12. Numerals assigned in ordinal rankings indicate an order of preference where the degree of preference among ranks is the same.

ANSWER: False

13. In a ratio scale, the zero point implies "nothingness," or the absence of the quality being measured.

ANSWER: True

14. Using ratio scale measurement is possible in accounting.

ANSWER: True

15. Objectivity may be defined as the degree of consensus among measurers.

ANSWER: True

16. Assessment measures are not concerned with particular attributes of objects.

ANSWER: False

17. Prediction measures are concerned with factors that may be indicative of future conditions.

ANSWER: True

18. Timeliness and cost are pertinent to assessment measures but are not pertinent to prediction measures.

ANSWER: False

19. All accounting measurements are of either the assessment or the prediction variety.

ANSWER: True

20. The need for information on a timely basis may conflict with cost constraints in some situations.

ANSWER: True

21. The terms *calculation* and *measurement* both refer to the valuation of a real phenomena or attribute.

ANSWER: False

22. Calculations attempt to simulate or come as close as possible to the measurement of real phenomena or attributes.

ANSWER: False

23. FIFO and LIFO measures of cost of goods sold and inventories are examples of calculations rather than measurements.

ANSWER: True

24. There are often trade-offs between objectivity and the usefulness of numbers generated by the measurement process.

ANSWER: True

25. Measurement is an integral part of accounting theory.

ANSWER: True

26. Throughout the financial history of the United States, current value has been the accepted valuation system for published financial statements.

ANSWER: False

27. The discounted cash flow approach can be used to determine an objective measurement for most assets and liabilities.

ANSWER: False

28. A general price-level adjustment refers to the purchasing power of the monetary unitary unit relative to all goods and services in the economy.

ANSWER: True

29. Both exit value and replacement cost are valuation systems that fall into the current value category.

ANSWER: True

30. The principal argument used to justify the replacement cost system over exit values is that if the great majority of the firm's assets were not already owned, it would be economically justifiable to acquire them.

ANSWER: True

MULTIPLE CHOICE QUESTIONS

1. Which of the following methods of valuing an asset is based on the amount that a firm could acquire by selling the asset?
- Replacement cost
 - Entry value
 - Exit value
 - Both a and b

ANSWER: C

2. Which of the following methods of valuing an asset is based on the amount that would be paid for it in markets where the asset would ordinarily be acquired?
- a. Replacement cost
 - b. Entry value
 - c. Exit value
 - d. Both a and b

ANSWER: D

3. Which of the following would be considered a political factor relative to the financial accounting policy function?
- a. Auditors
 - b. Inflation
 - c. Taxes
 - d. Price changes

ANSWER: A

4. Which of the following groups carry out most accounting research?
- a. Public accounting firms
 - b. Private industry
 - c. Accounting professors
 - d. Chartered Financial Analysts

ANSWER: C

5. If a number assigned to an object is an actual measurement of a property of the object, it is referred to as a(n):
- a. Direct measurement.
 - b. Biased measurement.
 - c. Indirect measurement.
 - d. Prediction measurement.

ANSWER: A

6. Which of the following factors is **not** listed in your text as affecting a direct assessment measure?
- a. The measurer
 - b. The attribute being measured
 - c. Instruments available for the measuring task
 - d. The individual who will use the measure

ANSWER: D

7. The simplest type of measuring system is the:
- a. Interval scale.
 - b. Ratio scale.
 - c. Nominal scale.
 - d. Ordinal scale.

ANSWER: C

8. Which measurement scale indicates an order of preference but not the degree of preference among ranks?
- a. Interval scale
 - b. Ratio scale
 - c. Nominal scale
 - d. Ordinal scale

ANSWER: D

9. The use of which of the following types of measurement scales in accounting allows meaningful comparisons among similar accounting measurements for different firms?
- a. Interval scale
 - b. Ratio scale
 - c. Nominal scale
 - d. Ordinal scale

ANSWER: B

10. For which measurement scale must the change in the attribute measured among assigned numbers be equal?
- a. Interval scale
 - b. Ratio scale
 - c. Ordinal scale
 - d. Both a and b

ANSWER: D

11. For which measurement scale must the change in the attribute measured among assigned numbers be equal and the zero point imply the absence of the attribute measured?
- a. Interval scale
 - b. Ratio scale
 - c. Ordinal scale
 - d. Both a and b

ANSWER: B

12. Which of the following is an example of a measurement rather than a calculation?
- a. FIFO inventory valuation
 - b. Replacement cost of ending inventory
 - c. LIFO cost of goods sold
 - d. Historical cost depreciation

ANSWER: B

13. In an accounting context, which of the following represents the degree of consensus among measurers in situations where a given group of measurers having similar instruments and constraints group measures the same attribute of a given object?
- a. Bias
 - b. Equality
 - c. Objectivity
 - d. Impartiality

ANSWER: C

14. In attempting to analyze the worth of an accounting measure, which of the following qualities is not mentioned in the text as an important consideration?
- a. Objectivity
 - b. Timeliness
 - c. Cost
 - d. Complexity

ANSWER: D

15. Which of the following is **not** a major input into the accounting standard-setting process?
- a. Accounting theory
 - b. Political factors
 - c. Geographical constraints
 - d. Economic conditions

ANSWER: C

16. Which of the following specifically refers to the process of arriving at a pronouncement issued by the FASB or SEC?
- a. Standard setting
 - b. Accounting research
 - c. Policy determination
 - d. Accounting valuation measurement

ANSWER: A

17. Which of the following is **not** true regarding accounting theory?
- a. It includes concepts, valuation models, and hypotheses.
 - b. It is developed and refined by the process of accounting research.
 - c. It is concerned with improving financial accounting and statement presentation.
 - d. It is concerned with insuring that managers and investors are in agreement on how to improve financial statements.

ANSWER: D

18. Which of the following refers to accounting information that is used by investors, creditors, and other outside parties for analyzing management performance and decision-making?
- a. Managerial accounting
 - b. Financial accounting
 - c. Income tax accounting
 - d. Institutional accounting

ANSWER: B

19. Computations and comparisons of accounting ratios is possible because:
- The zero point in accounting implies "nothingness" in terms of dollar amount.
 - Accounting measures are on an interval scale.
 - Assets and liabilities are listed in the order of liquidity in the balance sheet.
 - Accounting is a basic classification system.

ANSWER: A

20. Which of the following is a measure of predictive ability?
- Objectivity
 - Bias
 - Timeliness
 - Productivity

ANSWER: B

21. Which of the following has/have been the accepted valuation system for published financial statements throughout the financial history of the United States?
- Historical cost
 - Income tax valuation
 - Discounted cash flows
 - General price level

ANSWER: A

22. Which of the following valuation approaches has/have been defended as more suitable as a means for distributing income because it is not based on hypothetical opportunity cost figures?
- Income tax valuation
 - Discounted cash flows
 - Historical cost
 - Current value

ANSWER: C

23. Which of the following valuation approaches converts historical cost dollars by an index such as the Consumer Price Index?
- Current value
 - Discounted cash flows
 - Replacement cost
 - General price-level adjustment

ANSWER: D

24. Which of the following valuation methods is frequently referred to as a process of orderly liquidation?
- Exit valuation
 - Entry value
 - Replacement cost
 - Historical cost

ANSWER: A

25. Of the valuation systems discussed in your text, which one is purely theoretical, with virtually no operable practicability on a statement-wide basis?
- Current value
 - Discounted cash flows
 - General price-level adjustment
 - Historical cost

ANSWER: B

ESSAY QUESTIONS

1. What is the policy function performed by bodies such as the FASB and the SEC? List and discuss the three sources of inputs to the policy-making function.

ANSWER:

The policy function performed by the FASB and the SEC is called standard setting (or rule making) and specifically refers to the process of arriving at pronouncements issued by these bodies. The three sources of inputs to the policy-making function are **economic conditions, political factors, and accounting theory**. The steep inflation of the 1970s, which led the FASB to require the disclosure of information concerning price changes, is an example of an economic condition that affected policy making. Auditors, preparers of financial statements, investors, management of major firms, industry trade associations, and the public itself, who might be represented by Congress or government agencies, are all political factors influencing the policy-making process. Accounting theory is developed and refined by the process of accounting research. This research is primarily performed by accounting professors, but many individuals from policy-making organization, public accounting firms, and private industry also play an important part in the research process.

2. Discuss the difference between direct measurement and indirect measurement. Give examples of each in an accounting context.

ANSWER:

A direct measurement of a property is an actual measurement of the property. An indirect measurement is one that must be made by roundabout means. Direct measurements are generally preferable to indirect measures. A direct measurement of replacement cost for an item of ending inventory would be the current wholesale price (the actual price for which it could be currently purchased). An example of an indirect measurement would be an estimate of the replacement cost based on a combination of factors such as original cost, condition, estimated current selling price, and normal markup.

3. List the four types of measurement scales in order of measurement rigor. Describe and give examples of each type of scale.

ANSWER:

The four types of measurement scales listed in order of measurement rigor are: nominal, ordinal, interval, and ratio. A **nominal scale** is a basic classification system, or a system of names. A chart of accounts is an example of nominal classification in accounting. An **ordinal scale** indicates (ranks) degree of preference, but degrees of preference between ranks are not necessarily equal. Listing current assets and current liabilities in order of liquidity is an example of ordinal ranking. **Interval scales** also allow ranking of attributes, but the change in the attribute measured among assigned numbers must be equal. The Fahrenheit temperature scale is an example of an interval scale. The ratio scale also assigns equal value to the intervals between assigned numbers. However, unlike the interval scale, the zero point on a ratio scale indicates absence of the property measured. Because zero indicates "nothingness" in terms of dollar amounts, accounting numbers are based on a ratio scale.

4. Give at least three examples of how accounting numbers may affect social reality.

ANSWER:

Some examples of how accounting numbers affect social reality are as follows:

- (1) In a period of rising prices, LIFO inventory valuation generally results in lower income and, therefore, lower income taxes.
- (2) Income numbers can be instrumental in evaluating the performance of management, which can affect salaries and bonuses.
- (3) Income numbers and various balance sheet ratios can affect dividend payment and security prices.
- (4) Income numbers and balance sheet ratios can affect the firm's credit standing and therefore the cost of capital.

5. Identify four qualities that are pertinent to accounting measures.

ANSWER:

Four qualities that should be considered in analyzing the worth of a measure are:

- (1) Objectivity (verifiability) — the degree of consensus among measurers.
- (2) Bias (usefulness) — a measure of predictive ability.
- (3) Timeliness — measurements (financial statements) should be up-to-date.
- (4) Cost constraints — data are costly to produce.

6. Explain how a firm might use a *special purpose entity* (SPE) to subvert the standard-setting process.

ANSWER:

SPEs are arrangements whereby the firm and an outside equity investor jointly own an entity which may largely be a shell enterprise. SPEs allow firms to “park” liabilities on the SPE’s balance sheet if the outside equity investor owns as little as 3% of the SPE. Leaving the liability off its own balance sheet improves the firm’s debt-equity ratio.

7. List arguments for and arguments against the use of historical cost, general price-level adjustment, exit value (net realizable value) and replacement cost (entry value). Explain why the discounted cash flow method is virtually impossible to apply in a real situation.

ANSWER:

Historical cost

For: Historical cost is more objectively determinable and better understood than are other valuation systems. Historical costs have also been defended as more suitable as a means of distributing income among capital providers, officers and employees, and taxation agencies because it is not based on hypothetical opportunity cost figures.

Against: Opportunity cost valuations are more indicative of economic valuation than are historical costs. In a period of rising prices, attributes measured by historical costing methods generally have limited relevance to economic reality. There is also a serious additivity problem under historical costing because dollars of different purchasing power are added to or subtracted from each other.

General price-level adjustment

For: Price-level adjustments restore the additivity of amounts on the financial statements.

Against: Every item on the financial statements, except for monetary assets and liabilities, must be adjusted for price levels and restated in terms of the general purchasing power of the dollar during the current year.

Exit value (net realizable value)

For: The balance sheet reflects the net liquidity available to the enterprise in the ordinary course of operations, thus portraying the firm's ability to shift its presently existing resource into new opportunities. Also, all the measurements are additive since valuations are at the same time point and measure the same attribute. Exit valuation can be combined with general price-level adjustment to provide a more complete analysis of inflationary effects upon the firm.

Against: The relevance of net realizable value measurements for fixed assets is questionable when the firm intends to keep and utilize the great bulk of them for revenue production purposes in the foreseeable future. Also, exit value measurements are often unavailable for unique fixed assets such as land, buildings, and custom made equipment.

Replacement cost (entry value)

For: If the great majority of the firm’s assets were not already owned, it would be economically justifiable to acquire them. Replacement cost can also be combined with general price-level adjustment to provide a more complete analysis of inflationary effects upon the firm.

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Against: Market values are often unavailable for such unique fixed assets as land, buildings, and heavy equipment specially designed for a particular firm. Discounted cash flows would be virtually impossible to apply because many assets contribute jointly to the production of cash flows, so individual asset valuation could not be determined. Also, the future orientation of asset valuation and income determination leads to very formidable estimation problems, which would reduce objectivity in terms of the degree of consensus among measurers.