

Testbank

to accompany

Understanding Australian Accounting Standards

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John Wiley & Sons Australia, Ltd 2013

Chapter 2: Application of Accounting Theory

Learning Objectives:

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| Learning Objective 2.1 | Identify the major decision areas in accounting for transactions and other events. |
| Learning Objective 2.2 | Discuss the decisions to be made when considering accounting policy choice. |
| Learning Objective 2.3 | Explain how theories can enhance our understanding of accounting practice and distinguish between normative and positive theories used in accounting. |
| Learning Objective 2.4 | Explain the general tenets of positive accounting theory and its implications for accounting policy choice. |
| Learning Objective 2.5 | Compare the mechanistic hypothesis and the 'no effects' efficient market hypothesis and their implications for financial reporting. |

Chapter 2

Application of Accounting Theory

Testbank - Multiple choice

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

Learning Objective 2.1 Identify the major decision areas in accounting for transactions and other events.

- 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.

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

Learning Objective 2.2 Discuss the decisions to be made when considering accounting policy choice.

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

3. Normative theories:

Learning Objective 2.3: Explain how theories can enhance our understanding of accounting practice and distinguish between normative and positive theories used in accounting.

- *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.

4. Which of the following processes describe how positive theories are developed?

Learning Objective 2.3: Explain how theories can enhance our understanding of accounting practice and distinguish between normative and positive theories used in accounting.

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

5. Sally observes that 'Cash' account is an asset account and has a debit balance. She also notices that 'Inventory' 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?

Learning Objective 2.3: Explain how theories can enhance our understanding of accounting practice and distinguish between normative and positive theories used in accounting.

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

6. The followings are the limitations of inductive reasoning, except:

Learning Objective 2.3: Explain how theories can enhance our understanding of accounting practice and distinguish between normative and positive theories used in accounting.

- a. it does not attempt to improve current practices.
- *b. it may result in a logically valid, but not sound arguments.
- c. it does not question the appropriateness of the observed actions.
- d. it has a tendency of maintaining the existing state of affairs.

7. Which of the following statements is correct?

Learning Objective 2.3: Explain how theories can enhance our understanding of accounting practice and distinguish between normative and positive theories used in accounting.

- 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.

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

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

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

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

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

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

10. Which of the following statements is not derived from the agency theory?

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- a. Entities employ managers to conduct business on their behalf and to negotiate contracts with other parties.
- *b. An entity is the centre of contractual relationships, with different parties having rights and responsibilities under the 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.

11. An example of bonding costs is:

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- 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.

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

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

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

13. Which of the following contractual relationships is not the focus of positive accounting theory?

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

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

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

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- 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.

15. Which of the following problems arises within owner-manager agency relationships?

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

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

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

16. The risk aversion problem in shareholder-manager agency relationships arises because:

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- *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.

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

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- a. risk aversion.
- b. wealth maximisation.
- c. claim dilution.

- *d. price protection.

18. Debt covenants:

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- 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.

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

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

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

20. Which of the following statements about asset substitution is incorrect?

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- a. Managers have incentives to use debts 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. All of the options are correct.

21. An example of political costs is:

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- *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.

22. Under the debt hypothesis:

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- 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.

23. Which of the following statements apply to political cost hypothesis?

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- 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.

24. The following statements describe the mechanistic hypothesis, except:

Learning Objective 2.5: Compare the mechanistic hypothesis and the 'no effects' efficient market hypothesis and their implications for financial reporting.

- 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.

25. A market is efficient if:

Learning Objective 2.5: Compare the mechanistic hypothesis and the 'no effects' efficient market hypothesis and their implications for financial reporting.

- a. investors are able to earn profits by trading on information.
- b. it takes time for market to adjust 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.

26. Which of the following statements is not a market efficiency assumption?

Learning Objective 2.5: Compare the mechanistic hypothesis and the 'no effects' efficient market hypothesis and their implications for financial reporting.

- *a. Share price would adjust more rapidly to information contained in financial statements.
- b. All information is 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. There are no transaction costs in trading securities.

27. When market is in the semi-strong form of market efficiency:

Learning Objective 2.5: Compare the mechanistic hypothesis and the 'no effects' efficient market hypothesis and their implications for financial reporting.

- 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 not publicly available information.

28. Which form of market efficiency is the most relevant to financial reporting?

Learning Objective 2.5: Compare the mechanistic hypothesis and the 'no effects' efficient market hypothesis and their implications for 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.

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

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- a. implementing sound corporate governance.
- b. having financial statements audited.
- c. linking management's bonus to profits.
- *d. paying a portion of managerial remuneration as shares.

30. The following restrictions may be included in a debt covenant, except:

Learning Objective 2.4: Explain the general tenets of positive accounting theory and its implications for accounting policy choice.

- a. restriction in the amount of dividends distributed as a percentage of profit.
- *b. restriction in using fair value to measure value of assets.
- c. restriction in undertaking mergers and takeovers.
- d. restriction in the maximum level of borrowings.