

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

### True / False Questions

1. The primary function of financial accounting is to provide relevant financial information to parties external to business enterprises.

**TRUE**

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 1*

*Level of Learning: 1*

2. Accrual accounting attempts to measure revenues and expenses that occurred during accounting periods so they equal net operating cash flow.

**FALSE**

*AACSB: Reflective thinking*

*Blooms: Comprehension*

*Learning Objective: 2*

*Level of Learning: 1*

3. The FASB is currently the public sector organization responsible for setting accounting standards in the U.S.

**FALSE**

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 3*

*Level of Learning: 1*

4. The Public Reform and Investor Protection Act of 2002 (Sarbanes-Oxley) changed the entity responsible for setting auditing standards in the United States.

**TRUE**

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 4*

*Level of Learning: 1*

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5. A rules-based approach to standard setting stresses professional judgment as opposed to following a list of rules.

**FALSE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 4  
Level of Learning: 1*

6. Under federal securities laws, the SEC has the authority to set accounting standards in the U.S.

**TRUE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 4  
Level of Learning: 1*

7. The primary responsibility for properly applying GAAP when communicating with investors and creditors through financial statements lies with a firm's auditors.

**FALSE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 6  
Level of Learning: 1*

8. Auditors play an important role in the resource allocation process by adding credibility to financial statements.

**TRUE**

*AACSB: Reflective thinking  
Blooms: Comprehension  
Learning Objective: 6  
Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

9. Materiality can be affected by the dollar amount of an item, the nature of the item, or both.

**TRUE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 6  
Level of Learning: 1*

10. Conservatism is a desired qualitative characteristic of accounting information.

**FALSE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 6  
Level of Learning: 1*

11. Equity is a residual amount representing the owner's interest in the assets of the business.

**TRUE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 6  
Level of Learning: 1*

12. Revenues are inflows or other enhancements of assets or settlements of liabilities from activities that constitute the entity's ongoing operations.

**TRUE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 6  
Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

13. Gains or losses result, respectively, from the disposition of business assets for greater than, or less than, their book values.

**TRUE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 6  
Level of Learning: 1*

14. Comprehensive income is another term for net income.

**FALSE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 6  
Level of Learning: 1*

15. Determining fair value by calculating the present value of future cash flows is a level 1 type of input.

**FALSE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 8  
Level of Learning: 1*

16. *SFAC No. 157* doesn't change the situations in which fair value is used under current GAAP.

**TRUE**

*AACSB: Reflective thinking  
Blooms: Knowledge  
Learning Objective: 8  
Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

### Essay Questions

Listed below are ten terms followed by a list of phrases that describe or characterize five of the terms. Match each phrase with the correct term by placing the letter designating the best term in the space provided by the phrase.

**Terms:**

- A. Comprehensive income
- B. Distribution to owners
- C. Feedback value
- D. Gain
- E. Materiality
- F. Predictive value
- G. Relevance
- H. Reliability
- I. Representational faithfulness
- J. Timeliness

17. \_\_\_\_ Information is useful in projecting cash flows.

F

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

18. \_\_\_\_ Pertinent to the decision at hand.

G

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

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19. \_\_\_\_ Information is available prior to the decision.

J

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

20. \_\_\_\_ Decrease in equity due to transfers to owners.

B

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

21. \_\_\_\_ Information confirms expectations.

C

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

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- I. Representational faithfulness
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22. \_\_\_\_ Along with relevance, a primary decision-specific quality.

H

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

23. \_\_\_\_ Results if an asset is sold for more than book value.

D

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

24. \_\_\_\_ Agreement between a measure and what it purports to represent.

I

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

25. \_\_\_\_ The change in equity from nonowner transactions.

A

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

26. \_\_\_\_ Concerns the decision making impact of both the amount and nature of an item.

E

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

Listed below are ten terms followed by a list of phrases that describe or characterize five of the terms. Match each phrase with the correct term with their phrases by placing the letter designating the best term in the space provided by the phrase.

**Terms:**

- A. Comparability
- B. Consistency
- C. Cost effectiveness
- D. Economic entity assumption
- E. Going concern assumption
- F. Monetary unit assumption
- G. Neutrality
- H. Periodicity assumption
- I. Recognition
- J. Verifiability

27. \_\_\_\_ Important in analysis between firms.

A

*AACSB: Reflective thinking*  
*Blooms: Comprehension*



## Chapter 001 Environment and Theoretical Structure of Financial Accounting

28. \_\_\_\_ Accounting information should be unbiased.

G

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

29. \_\_\_\_ The process of including data in financial statements.

I

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

30. \_\_\_\_ Applying the same accounting practices over time.

B

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

31. \_\_\_\_ Considers the value of using information relative to cost of providing it.

C

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

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- I. Recognition
- J. Verifiability

32. \_\_\_\_ Implies consensus among different observers.

J

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

33. \_\_\_\_ Assumes all transactions can be identified with a particular entity.

D

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

34. \_\_\_\_ Assumes an entity will continue to operate indefinitely.

E

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

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35. \_\_\_\_ Requires reporting the financial life of an entity in discrete time frames.

H

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

36. \_\_\_\_ Ignores the possibility of inflation.

F

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

Listed below are ten terms followed by a list of phrases that describe or characterize five of the terms. Match each phrase with the correct term by placing the letter designating the best term in the space provided by the phrase.

**Terms:**

- A. Accounting Principles Board
- B. AICPA
- C. Conservatism
- D. Financial Accounting Standards Board
- E. Full-disclosure principle
- F. Historical cost principle
- G. Matching principle
- H. Materiality
- I. Realization principle
- J. Securities and Exchange Commission

37. \_\_\_\_ Basis of measurement for fixed assets.

F

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

38. \_\_\_\_ Recognition of revenue only after certain criteria are satisfied.

I

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

39. \_\_\_\_ Guide to expense recognition.

G

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

40. \_\_\_\_ Reporting of all information that could affect decisions.

E

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

41. \_\_\_\_ Application of GAAP sometimes avoided under this constraint.

H

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

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- J. Securities and Exchange Commission

42. \_\_\_\_ It is a practical justification for choosing among alternative accounting methods.

C

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

43. \_\_\_\_ Its pronouncements are still GAAP unless superseded by the FASB.

A

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

44. \_\_\_\_ Its *EITF Issues* are considered part of GAAP.

D

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

45. \_\_\_\_ It has the authority to set U.S. accounting standards.

J

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

46. \_\_\_\_ It is the national organization for CPAs in the U.S.

B

*AACSB: Reflective thinking*  
*Blooms: Comprehension*

Listed below are ten terms followed by a list of phrases that describe or characterize five of the terms. Match each phrase with the correct term by placing the letter designating the best term in the space provided by the phrase.

**Terms:**

- A. Assets
- B. Comprehensive income
- C. Distributions to owners
- D. Equity
- E. Expenses
- F. Gains
- G. Investments by owners
- H. Liabilities
- I. Losses
- J. Revenues

47. \_\_\_\_ Net assets.

D

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

48. \_\_\_\_ Outflows of resources to generate revenues.

E

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

49. \_\_\_\_ Cash dividends.

C

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

50. \_\_\_\_ Claims of creditors against the assets of a business.

H

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

51. \_\_\_\_ Transfers of resources in exchange for common and preferred stock.

G

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

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- I. Losses
- J. Revenues

52. \_\_\_\_ Net outflows from peripheral transactions.

I

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

53. \_\_\_\_ Increases in equity from the sale of goods and/or services.

J

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

54. \_\_\_\_ Net inflows generally reported as part of nonoperating income.

F

*AACSB: Reflective thinking*  
*Blooms: Knowledge*



## Chapter 001 Environment and Theoretical Structure of Financial Accounting

55. \_\_\_\_ All changes in equity except owner transactions.

B

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

56. \_\_\_\_ Probable future economic benefits controlled by an entity.

A

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

Listed below are ten organizations followed by a list of phrases that describe or characterize the organizations. Match each phrases with the correct organization by placing the letter designating the best term in the space provided by the phrase.

**Organization:**

- A. IASB
- B. FASB
- C. IASC
- D. SEC
- E. APB
- F. EITF
- G. AICPA
- H. FAF
- I. PCAOB
- J. IMA

57. \_\_\_\_ Responsible for establishing auditing standards in the U.S.

I

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

58. \_\_\_\_ Primary national organization of accountants working in industry.

J

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

59. \_\_\_\_ Sets accounting standards in the U.S.

B

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

60. \_\_\_\_ Provides timely responses to financial reporting issues.

F

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

61. \_\_\_\_ The FASB's parent organization.

H

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

62. \_\_\_\_ Parent organization of the IASB.

C

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

63. \_\_\_\_ FASB's predecessor.

E

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

64. \_\_\_\_ Regulates the financial reporting for public companies.

D

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

65. \_\_\_\_ National organization of certified public accountants.

G

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

66. \_\_\_\_ Sets global accounting standards.

A

*AACSB: Reflective thinking*  
*Blooms: Knowledge*

**Multiple Choice Questions**

67. External decision makers would not look primarily to financial accounting information to assist them in making decisions on:

- A. Granting credit.
- B. Capital budgeting.**
- C. Selecting stocks.
- D. Mergers and acquisitions.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 1*  
*Level of Learning: 1*

68. Corporations issue their shares to the investing public in the:

Primary market	Secondary market
A. Yes	Yes
B. No	Yes
<b>C. Yes</b>	No
D. No	No

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 1*  
*Level of Learning: 1*

69. The primary focus for financial accounting information is to provide information useful for:

Investing decisions	Credit decisions
<b>A. Yes</b>	Yes
B. Yes	No
C. No	Yes
D. No	No

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 1*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

70. Which of the following is not true about net operating cash flow?

A. It is the difference between cash receipts and cash disbursements from providing goods and services.

**B.** It is a measure used in accrual accounting and is recognized as the best predictor of future operating cash flows.

C. Over short periods of time, it may not be indicative of long-run cash-generating ability.

D. It is easy to understand and all information required to measure it is factual.

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 1*

*Level of Learning: 2*

71. Which of the following groups is not among financial intermediaries?

A. Mutual fund managers

B. Financial analysts

**C.** CPAs

D. Credit rating organizations

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 1*

*Level of Learning: 2*

72. Which of the following was the first private sector entity that set accounting standards in the United States?

A. Accounting Principles Board

**B.** Committee on Accounting Procedure

C. Financial Accounting Standards Board

D. AICPA

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 1*

*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

73. Which of the following does not apply to secondary markets?

- A. Transactions are important to the efficient allocation of resources in our economy.
- B.** New resources are provided when shares of stock are sold by the corporation to the initial owners.
- C. Transactions help to establish market prices for additional shares that may be issued in the future.
- D. Many investors might be unwilling to provide resources to corporations if there is no available mechanism for the future sale of their stocks and bonds to others.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 2*  
*Level of Learning: 2*

74. A cause-and-effect relationship is implicit in the:

- A. Realization principle.
- B. Historical cost principle.
- C.** Matching principle.
- D. Going concern assumption.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 2*  
*Level of Learning: 2*

75. The full disclosure principle requires a balance between:

- A. Comparability and consistency.
- B.** Relevance and cost effectiveness.
- C. Reliability and neutrality.
- D. Timeliness and predictive value.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 2*  
*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

76. Which of the following groups is not among the external users for whom financial statements are prepared?

- A. Customers
- B. Suppliers
- C. Employees
- D.** All of these are external users of financial statements.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 2*  
*Level of Learning: 2*

77. In a recent annual report, Apple Computer reported the following in one of its disclosure notes: "Warranty Expense: The Company provides currently for the estimated cost for product warranties at the time the related revenue is recognized." This note exemplifies Apple's use of:

- A. Conservatism
- B.** The matching principle
- C. Realization principle
- D. Full disclosure principle

*AACSB: Reflective thinking*  
*Blooms: Synthesis*  
*Learning Objective: 2*  
*Level of Learning: 2*

78. GAAP is an abbreviation for:

- A. Generally authorized accounting procedures.
- B. Generally applied accounting procedures.
- C. Generally accepted auditing practices.
- D.** Generally accepted accounting principles.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 3*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

79. The SEC issues accounting standards in the form of:

- A. Accounting Research Bulletins.
- B. Financial Reporting Releases.**
- C. Financial Accounting Standards.
- D. Financial Technical Bulletins.

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 3*

*Level of Learning: 1*

80. Pronouncements issued by the Committee on Accounting Procedures:

- A. Dealt with specific accounting and reporting problems.**
- B. Were based on exposure drafts and public comment letters.
- C. Originated from congressional studies and SEC directives.
- D. Were the outcome of research studies and a theoretical framework.

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 3*

*Level of Learning: 1*

81. The FASB's standard-setting process includes, in the correct order:

- A. Exposure draft, research, discussion memorandum, SFAS.
- B. Research, exposure draft, discussion memorandum, SFAS.
- C. Research, discussion memorandum, exposure draft, SFAS.**
- D. Discussion memorandum, research, exposure draft, SFAS.

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 3*

*Level of Learning: 1*



## Chapter 001 Environment and Theoretical Structure of Financial Accounting

82. Which of the following is *not* a provision of the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley)? The Act

- A. Changed the entity responsible for setting auditing standards.
- B. Increased corporate executive responsibility for financial statements.
- C. Limited nonaudit services that can be performed by auditors for audit clients.
- D.** Changed the entity responsible for setting accounting standards.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 3*  
*Level of Learning: 1*

83. CPAs are licensed by:

- A. The AICPA.
- B. The SEC.
- C. The federal government.
- D.** State governments.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 3*  
*Level of Learning: 1*

84. A firm's comprehensive income is always:

- A. The same as its net income.
- B. Greater than its net income.
- C. Less than its net income.
- D.** Could be greater than or less than net income.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 3*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

85. Which of the following has the authority to set accounting standards in the United States?

- A. FASB
- B. IRS
- C. SEC**
- D. AICPA

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 3*  
*Level of Learning: 1*

86. The most likely important flaw leading to the demise of the APB was the perceived lack of:

- A. Confidence.
- B. Competence.
- C. Independence.**
- D. Importance.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 3*  
*Level of Learning: 2*

87. Accounting standard setting has been characterized as:

- A. A political process.**
- B. Using the scientific method.
- C. Pure deductive reasoning.
- D. Pure inductive reasoning.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 4*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

88. The International Accounting Standards Board:

- A. Was the predecessor to the IASC.
- B. Can overrule the FASB when their policies disagree.
- C.** Promotes the use of high-quality, understandable global accounting standards.
- D. Has its headquarters in Geneva.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 4*  
*Level of Learning: 1*

89. The most political issue in the FASB's most recent deliberations and pronouncements on business combinations was:

- A.** The negative effects on subsequent earnings of amortizing goodwill if firms were required to use the purchase method of accounting for the combination.
- B. The negative effects on subsequent earnings of amortizing goodwill if firms were required to use the pooling method of accounting for the combination.
- C. The unrealistic balance sheet assets that would be created if firms were required to use the purchase method of accounting for the combination.
- D. The unrealistic balance sheet assets that would be created if firms were required to use the pooling method of accounting for the combination.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 4*  
*Level of Learning: 1*

90. Which of the following is not a provision of the Public Company Accounting Reform and Investor Protection Act of 2002?

- A. Corporate executive accountability.
- B. Auditor rotation.
- C. Retention of workpapers.
- D.** All of these are provisions of the Act.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 4*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

91. When a registrant company submits its annual filing to the SEC, it uses:

- A. Form 10-A.
- B. Form 10-K.**
- C. Form 10-Q.
- D. Form S-1.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 4*  
*Level of Learning: 1*

92. The primary professional organization for those accountants working in industry is the:

- A. AAA
- B. AICPA
- C. IIA
- D. IMA**

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 4*  
*Level of Learning: 1*

93. The FASB issues a Statement of Accounting Standards if \_\_\_\_\_ FASB members support it.

- A. 5 of 9
- B. 5 of 7
- C. 4 of 7**
- D. None of these is correct.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 4*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

94. The primary historical reason for the FASB reversing its positions when political pressures occur is:

- A. The cost gathering data was prohibitive.
- B. The difficulties in measurement were too great.
- C. They have no authority in such situations.
- D.** The SEC did not support the FASB position.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 4*  
*Level of Learning: 2*

95. The most recent example of the political process at work in standard setting is the heated debate that occurred on the issue of:

- A. Pension plan accounting.
- B. Accounting for posteretirement benefits other than pensions.
- C.** Accounting for business combinations.
- D. Accounting for stock-based compensation.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 4*  
*Level of Learning: 2*

96. The recognition of which of the following expenses exemplifies the application of the matching principle?

- A. President's salary.
- B. Research and development.
- C.** Cost of goods sold.
- D. Advertising.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 4*  
*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

97. The FASB's conceptual framework's qualitative characteristics of accounting information include:

- A. Historical cost.
- B. Realization.
- C. Reliability.**
- D. Full disclosure.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 5*  
*Level of Learning: 1*

98. The FASB's conceptual framework's qualitative characteristics of accounting information include:

- A. Full disclosure.
- B. Relevance.**
- C. Going concern.
- D. Historical cost.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 5*  
*Level of Learning: 1*

99. The conceptual framework's qualitative characteristic of relevance includes:

- A. Timeliness.**
- B. Verifiability.
- C. Representational faithfulness.
- D. Neutrality.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 5*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

100. The conceptual framework's qualitative characteristic of reliability includes:

- A. Predictive value.
- B.** Neutrality.
- C. Feedback value.
- D. Timeliness.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 5*  
*Level of Learning: 1*

101. The conceptual framework's recognition and measurement concepts recognize which of the following as an assumption, rather than a principle?

- A.** Going concern.
- B. Historical cost.
- C. Full disclosure.
- D. Realization.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 5*  
*Level of Learning: 1*

102. The conceptual framework's recognition and measurement concepts recognize which of the following as a principle, rather than an assumption?

- A. Periodicity.
- B. Monetary unit.
- C. Conservatism.
- D.** Full disclosure.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 5*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

103. SFAC No.1 focuses on:

- A. Objectives of financial reporting.
- B. Qualitative characteristics of accounting information.
- C. Recognition and measurement concepts in accounting.
- D. Elements of financial statements.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 5*  
*Level of Learning: 1*

104. Financial accounting information should provide information about:

- A. Resources of an enterprise.
- B. Claims to resources.
- C. The effects of transactions that cause changes in resources.
- D. All of these.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 5*  
*Level of Learning: 2*

105. SFAC No.5 focuses on:

- A. Objectives of financial reporting.
- B. Qualitative characteristics of accounting information.
- C. Recognition and measurement concepts in accounting.
- D. Elements of financial statements.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 5*  
*Level of Learning: 2*



## Chapter 001 Environment and Theoretical Structure of Financial Accounting

106. The main issue in the debate over accounting for employee stock options was:

- A. Which employees should receive options.
- B.** The amount of compensation expense that a company should recognize.
- C. How many options should be granted to key executives.
- D. The tax consequences of employee stock options.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 5*  
*Level of Learning: 2*

107. Net income equals:

- A. Assets minus liabilities.
- B. Revenues minus cost of goods sold.
- C.** Revenues minus expenses.
- D. Cash receipts minus cash payments.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 1*

108. Financial reporting objectives state that financial statements should be comprehensible to

- A. Accounting experts.
- B.** Those who have a reasonable understanding of business and economic activities and are willing to study the information.
- C. Large investors.
- D. The average investor with average communication skills and average training and experience.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

109. Financial reporting objectives do not include providing information:

- A. About resources, obligations, and changes.
- B.** To determine market values, assess profit potential, and evaluate management.
- C. To assess the amounts and timing of prospective cash receipts.
- D. To make rational investment, credit, and similar decisions.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 1*

110. Primary qualitative characteristics of accounting information are:

- A. Relevance and comparability.
- B. Comparability and consistency.
- C.** Reliability and relevance.
- D. Reliability and consistency.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 1*

111. Secondary qualitative characteristics of accounting information include:

- A. Relevance and comparability.
- B.** Comparability and consistency.
- C. Reliability and relevance.
- D. Reliability and consistency.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

112. Gains are:

- A. Inflows from selling a product or service to a customer.
- B. Increases in equity resulting from transfers of assets to the company from owners.
- C.** Increases in equity from peripheral transactions of an entity.
- D. None of these.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 1*

113. When there is agreement between a measure or description and the phenomenon it purports to represent, information possesses which characteristic?

- A. Verifiability.
- B. Predictive value.
- C.** Representational faithfulness.
- D. Timeliness.

*AACSB: Reflective thinking*  
*Blooms: Synthesis*  
*Learning Objective: 6*  
*Level of Learning: 1*

114. Surefeet Corporation changed its inventory valuation method. Which characteristic is jeopardized by this change?

- A. Comparability.
- B. Representational faithfulness.
- C.** Consistency.
- D. Feedback value.

*AACSB: Reflective thinking*  
*Blooms: Synthesis*  
*Learning Objective: 6*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

115. Of the following, the most important objective for financial reporting is to provide information useful for:

- A. Predicting cash flows.
- B. Determining taxable income.
- C. Providing accountability.
- D. Increasing future profits.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 2*

116. Independent auditors express an opinion on the:

- A. Fairness of financial statements.
- B. Accuracy of financial statements.
- C. Soundness of a company's future.
- D. Quality of a company's management.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 2*

117. If an independent auditing firm expresses dissatisfaction with a company's financial statements, it issues:

- A. A qualified opinion.
- B. An unqualified opinion.
- C. A disqualified opinion.
- D. A rejection of opinion.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

118. Constraints on qualitative characteristics of accounting information include:

- A. Timeliness.
- B. Going concern.
- C. Neutrality.
- D.** Conservatism.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 2*

119. Elements of financial statements do not include:

- A.** Monetary unit.
- B. Investments by owners.
- C. Comprehensive income.
- D. Losses.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 2*

120. According to the conceptual framework, verifiability implies:

- A. Legal evidence.
- B. Logic.
- C.** Consensus.
- D. Legal verdict.

*AACSB: Reflective thinking*  
*Blooms: Synthesis*  
*Learning Objective: 6*  
*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

121. Land was acquired in 2009 for a future building site at a cost of \$40,000. The assessed valuation for tax purposes is \$27,000, a qualified appraiser placed its value at \$48,000, and a recent firm offer for the land was for a cash payment of \$46,000. The land should be reported in the financial statements at:

- A.** \$40,000.
- B. \$27,000.
- C. \$46,000.
- D. \$48,000.

*AACSB: Analytic*  
*Blooms: Application*  
*Learning Objective: 6*  
*Level of Learning: 2*

122. Maltec Corporation has started placing its quarterly financial statements on its web page, thereby reducing by ten days the time to get information to investors and creditors. The qualitative concept improved is:

- A. Comparability.
- B. Consistency.
- C.** Relevance.
- D. Reliability.

*AACSB: Reflective thinking*  
*Blooms: Synthesis*  
*Learning Objective: 6*  
*Level of Learning: 2*

123. Recognizing expected losses immediately, but deferring expected gains, is an example of:

- A. Materiality.
- B.** Conservatism.
- C. Cost effectiveness.
- D. Timeliness.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

124. Change in equity from nonowner sources is:

- A.** Comprehensive income.
- B. Revenues.
- C. Expenses.
- D. Gains and losses.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 2*

125. The assumption that in the absence of contrary information a business entity will continue indefinitely is the:

- A. Periodicity assumption.
- B. Entity assumption.
- C.** Going concern assumption.
- D. Historical cost assumption.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 2*

126. Which of the following Statements of Financial Accounting Concepts defines the 10 elements of financial statements?

- A. SFAC 1
- B. SFAC 2
- C. SFAC 5
- D.** SFAC 6

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

127. The possibility that the capital markets' focus on periodic profits may tempt a company's management to bend or even break accounting rules to inflate reported net income is an example of:

- A.** An ethical dilemma.
- B. An accounting theory issue.
- C. A technical accounting issue.
- D. None of these is correct.

*AACSB: Reflective thinking*  
*Blooms: Synthesis*  
*Learning Objective: 6*  
*Level of Learning: 2*

128. One of the elements that many believe distinguishes a profession from other occupations is the acceptance by its members of a responsibility for the interests of those it serves, often articulated in:

- A. Its conceptual framework.
- B.** Its code of ethics.
- C. Federal laws.
- D. State laws.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 6*  
*Level of Learning: 2*

129. Primecoat could get its annual financial statements two days earlier if it shifted substantial human resources from other operations to the annual report project. Management decided the value of the earlier report was not worth the added commitment of resources. The concept demonstrated is:

- A. Timeliness.
- B. Materiality.
- C. Relevance.
- D.** Cost effectiveness.

*AACSB: Reflective thinking*  
*Blooms: Application*  
*Learning Objective: 6*  
*Level of Learning: 2*



## Chapter 001 Environment and Theoretical Structure of Financial Accounting

130. Mega Loan Company has very stringent credit requirements and, accordingly, has negligible losses from uncollectible accounts. The company's independent accountants did not protest when, contrary to GAAP, the company recorded bad debt expense only when specific accounts were determined to be uncollectible, rather than use an allowance for uncollectible accounts. The concept demonstrated is:

- A. Comparability.
- B. Representational faithfulness.
- C. Cost effectiveness.
- D.** Materiality.

*AACSB: Reflective thinking*  
*Blooms: Application*  
*Learning Objective: 6*  
*Level of Learning: 2*

131. The best argument in support of historical cost information is:

- A. Relevance.
- B. Predictive quality for future cash flows.
- C. Materiality.
- D.** Verifiability.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 7*  
*Level of Learning: 1*

132. If a company has gone bankrupt, its financial statements likely violate:

- A. The matching principle.
- B. The realization principle.
- C. The stable monetary unit assumption.
- D.** The going concern assumption.

*AACSB: Reflective thinking*  
*Blooms: Synthesis*  
*Learning Objective: 7*  
*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

133. Revenue should not be recognized until:

- A. The earnings process is complete and collection is reasonably assured.
- B. Contracts have been signed and payment has been received.
- C. Work has been performed and customer has been billed.
- D. Collection has been made and warranties have expired.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 7*  
*Level of Learning: 2*

134. Which of the following is not an identified valuation technique in *SFAS No. 157*?

- A. Cost approach.
- B. Market approach.
- C. Cost-benefit approach.
- D. Income approach.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 8*  
*Level of Learning: 1*

135. Disclosure notes to a company's financial statements:

- A. Are relatively unimportant facts that don't belong in the basic financial statements.
- B. Document the source of financial statement facts, like literary footnotes.
- C. Are an integral part of a company's financial statements.
- D. Are irrelevant facts that are immaterial in amount.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 8*  
*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

136. Which of the following best demonstrates the full disclosure principle:

- A. The multi-step income statement.
- B. The auditors' report.
- C. The company's tax return.
- D.** Disclosure notes to financial statements.

*AACSB: Reflective thinking*

*Blooms: Synthesis*

*Learning Objective: 8*

*Level of Learning: 2*

137. Four different competent accountants independently agree on the amount and method of reporting an economic event. The concept demonstrated is:

- A. Reliability.
- B. Comparability.
- C. Representational faithfulness.
- D.** Verifiability.

*AACSB: Reflective thinking*

*Blooms: Comprehension*

*Learning Objective: 8*

*Level of Learning: 2*

138. The matching principle is:

- A. A valuation method.
- B.** An expense recognition accounting principle.
- C. A cash basis reporting principle.
- D. An asset classification procedure.

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 8*

*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

139. To meet the needs of full disclosure, companies use supplemental information, including:
- A. Parenthetical comments or modifying comments placed on the face of the financial statements.
  - B. Disclosure notes conveying additional insights about company operations, accounting principles, contractual agreements, and pending litigation.
  - C. Supplemental financial statements that report more detailed information than is shown in the primary financial statements.
  - D.** All of these are correct.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 8*  
*Level of Learning: 2*

140. Ford Motor Company purchases services from suppliers on account and sells its products to distributors on short-term credit. As a result, do each of these affect net income faster than they affect net operating cash flows?

Purchase Services	Sell Products
<b><u>A.</u></b> Yes	Yes
B. Yes	No
C. No	Yes
D. No	No

*AACSB: Analytic*  
*Blooms: Analysis*  
*Learning Objective: 8*  
*Level of Learning: 3*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

### Essay Questions

Alpaca Corporation had revenues of \$200,000 in its first year of operations. They have not collected on \$20,000 of their sales, and still owe \$25,000 on \$70,000 of merchandise they purchased. The company paid \$15,000 in salaries. The company had no inventory on hand at the end of the year. Owners invested \$20,000 in the business and \$20,000 was borrowed on a five-year note. The company paid \$2,000 in interest that was the amount owed for the year, and paid \$6,000 for a two-year insurance policy on the first day of business. Alpaca has an effective income tax rate of 40%.

141. Compute net income for the first year for Alpaca Corporation.

Revenues		\$200,000
Expenses:		
Cost of goods sold	70,000	
Salaries	15,000	
Interest	2,000	
Insurance	<u>3,000</u>	<u>90,000</u>
Income before tax		110,000
Income tax at 40%		<u>44,000</u>
Net income		<u>\$ 66,000</u>

*AACSB: Analytic*  
*Blooms: Application*  
*Learning Objective: 2*  
*Level of Learning: 3*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

142. Compute the cash balance at the end of the first year for Alpaca Corporation.

Cash receipts:		
Sales revenue	\$200,000	
Less: Accounts receivable	<u>20,000</u>	\$180,000
Owners' investments		20,000
Note payable		<u>20,000</u>
Total receipts		<u>220,000</u>
Cash disbursements:		
Purchases	70,000	
Less: Accounts payable	<u>25,000</u>	\$ 45,000
Salaries paid		15,000
Interest paid		2,000
Insurance paid		6,000
Estimated taxes paid		<u>44,000</u>
Total cash disbursements		<u>112,000</u>
Ending cash balance		<u>\$108,000</u>

*AACSB: Analytic*  
*Blooms: Application*  
*Learning Objective: 2*  
*Level of Learning: 3*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

Tri Fecta, a partnership, had revenues of \$360,000 in its first year of operations. The partnership has not collected on \$35,000 of its sales, and still owes \$40,000 on \$150,000 of merchandise they purchased. There was no inventory on hand at the end of the year. The partnership paid \$25,000 in salaries. The partners invested \$40,000 in the business and \$25,000 was borrowed on a five-year note. The partnership paid \$3,000 in interest that was the amount owed for the year and paid \$8,000 for a two-year insurance policy on the first day of business.

143. Compute net income for the first year for Tri Fecta.

Revenues		\$360,000
Expenses:		
Cost of Goods Sold	\$150,000	
Salaries	25,000	
Interest	3,000	
Insurance	<u>4,000</u>	<u>182,000</u>
Net income		<u>\$178,000</u>

*AACSB: Analytic*  
*Blooms: Application*  
*Learning Objective: 2*  
*Level of Learning: 3*





## Chapter 001 Environment and Theoretical Structure of Financial Accounting

The following information (\$ in millions) comes from the 2006 annual report of Amazon.com, Inc.:

Net sales	\$10,711
Total assets	4,363
End of year balance in cash	1,022
Total stockholders' equity	431
Gross profit (Sales – Cost of Sales).	2,456
Net increase in cash for the year	9
Operating expenses	2,067
Net operating cash flow	702
Other income (expense), net	(12)

145. Compute Amazon's balance in cash at the beginning of 2006.

Beginning balance in Cash + Net increase in Cash = Ending balance in Cash  
Therefore, beginning balance in Cash = Ending balance in Cash – Net increase in Cash  
= \$1,022 – 9 = \$1,013

*AACSB: Analytic*  
*Blooms: Application*  
*Learning Objective: 2*  
*Level of Learning: 3*

146. Compute Amazon's total liabilities at the end of 2006.

Total assets = Total liabilities + Total Stockholders' equity  
Therefore, Total liabilities = Total assets – Total Stockholders' equity =  
\$4,363 – 431 = \$3,932

*AACSB: Analytic*  
*Blooms: Application*  
*Learning Objective: 2*  
*Level of Learning: 3*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

147. Compute the 2006 cost of goods sold for Amazon.

$$\begin{aligned}\text{Gross profit} &= \text{Net sales} - \text{Cost of goods sold} \\ \text{Therefore, Cost of goods sold} &= \text{Net sales} - \text{Gross profit} \\ &= \$10,711 - 2,456 = \underline{\$8,255}\end{aligned}$$

*AACSB: Analytic*  
*Blooms: Application*  
*Learning Objective: 2*  
*Level of Learning: 3*

148. Compute the 2006 income before income tax for Amazon.

$$\begin{aligned}\text{Net income} &= \text{Gross profit} - \text{Operating expenses} + \text{Other income (expense), net} \\ &= \$2,456 - 2,067 + (12) = \underline{\$377}\end{aligned}$$

*AACSB: Analytic*  
*Blooms: Application*  
*Learning Objective: 2*  
*Level of Learning: 3*

149. Compare the 2006 net income (loss) for Amazon.com to its net cash flow from operating activities. Why are these amounts different? Briefly explain.

These amounts are different because of the differences between cash and accrual accounting. As opposed to cash flows from operations, net income includes both revenues and expenses the timing of which differs from the timing of certain cash receipts and payments. Examples would be credit sales in which the revenues are recorded before the collection of cash and cost of goods sold in which the expense often is recorded later than the cash payment to the supplier for the merchandise.

*AACSB: Analytic*  
*Blooms: Comprehension*  
*Learning Objective: 2*  
*Level of Learning: 3*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

150. For each of the following situations, state whether you agree or disagree with the financial reporting practice employed, and briefly explain the reason for your answer.

1. Cantor Corporation's accountant increased the book value of a patent from its original cost of \$1 million to its recently appraised value of \$6 million.

2. Stanton Corporation paid for the personal travel of its chief financial officer and charged travel expense.

3. At the end of its 2009 fiscal year, Dower, Inc. received an order from a customer for \$60,000. The merchandise will ship early in 2010. Because the sale was made to a long-time customer and the invoice was paid in 2009, the controller recorded the sale in 2009.

4. In the middle of its 2009 fiscal year, Sanguinetti, Inc. paid \$12,000 to its insurance company for one-year comprehensive insurance coverage. Sanguinetti recorded the entire expenditure as an expense in 2009.

5. The Churchill Pharmaceutical Company included a note in its financial statements that described a pending lawsuit against the company.

6. The Daily Corporation, a company whose securities are publicly traded, prepares monthly, quarterly, and annual financial statement for internal use but disseminates to external users only the annual financial statements.

1. Disagree — This is a violation of the historical cost (original transaction value) principle.

2. Disagree — This is a violation of the economic entity assumption.

3. Disagree — This is a violation of the realization (revenue recognition) principle.

4. Disagree — This is a violation of the matching principle.

5. Agree — The company is conforming to the full disclosure principle.

6. Disagree — This is a violation of the periodicity assumption.

*AACSB: Analytic*  
*Blooms: Application*  
*Learning Objective: 7*  
*Learning Objective: 8*  
*Level of Learning: 3*

151. Identify or define the following terms: a. economic entity, b. going concern.

Economic entity - All economic events can be identified with a particular economic entity.

Going concern - In the absence of information to the contrary, it is anticipated that a business entity will continue to operate indefinitely.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 1*  
*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

152. List the four financial statements most frequently provided to external users.

Balance sheet, Income statement, Statement of cash flows, Statement of shareholders' equity.

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 2*

*Level of Learning: 1*

153. Explain and show an example of how the FASB's conceptual framework is needed in formulating standards on controversial topics.

There are many possible examples here. For example, in debating accounting for stock-based compensation, the FASB's conceptual framework explains the rationale for treating stock options as an expense. By relating the accounting for such compensation to the purpose of financial statements and their qualitative characteristics, the FASB can defend its positions without the bias inherent in such controversial issues.

*AACSB: Reflective thinking*

*Blooms: Comprehension*

*Learning Objective: 3*

*Level of Learning: 3*

154. What is the SEC and how is it involved with accounting standard setting?

The Securities and Exchange Commission is a federal agency that has the authority to set accounting standards. However, the SEC has always delegated the task to a private sector body, such as the current FASB. The SEC's 10K & 10Q filing requirements call for more detailed disclosures than those required by GAAP.

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 4*

*Level of Learning: 1*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

155. What is the EITF and what is its purpose?

The Emerging Issues Task Force (EITF) acts as a filter for the FASB. It includes 15 individuals from public accounting and private industry along with a representative from the FASB and an SEC observer. The task force focuses on emerging issues and attempts to reach a consensus, speeding up the standard-setting process.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 4*  
*Level of Learning: 2*

156. Accounting standard setting has been characterized as a political process. Discuss this proposition giving an example.

Changes in standards can have significant differential effects on companies, investors, creditors, and other interest groups. The FASB must gauge the economic consequences of a change in accounting standards. The process by which financial accounting standards are created includes public comment and sometimes hearings. Ultimately, a vote must be taken to pass a standard. Accounting for stock-based compensations (options) and post-retirement health care benefits are examples where accounting practices have been affected by political influences on GAAP.

*AACSB: Reflective thinking*  
*Blooms: Synthesis*  
*Learning Objective: 4*  
*Level of Learning: 2*

157. What are the key provisions of the Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002?

The act provides for the regulation of auditors and the types of services they furnish to clients, increases accountability of corporate executives, addresses conflicts of interest for auditors and securities analysts, and requires that companies document and assess their internal controls, that auditors express an opinion on management's assessment of internal controls, and requires auditors to express their own opinion on company internal controls.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 4*  
*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

158. How does the value of an audit affect financial statements?

Outside auditors add credibility to financial statements, increasing the confidence of capital market participants who rely on financial statements in making investment and credit decisions and recommendations.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 4*  
*Level of Learning: 3*

159. What provisions did the Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002 make for performance of non-audit services by an audit firm?

The law makes it unlawful for the auditors of public companies to perform a variety of non-audit services for audit clients. Prohibited services include bookkeeping, internal audit outsourcing, appraisal or valuation services, and various other consulting services. Other non-audit services, including tax services, require pre-approval by the audit committee of the company being audited.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 4*  
*Level of Learning: 2*

160. Briefly describe the materiality constraint.

Materiality - Information is material if it can have an effect on a decision made by a user. If an item is not material, GAAP need not be followed. For example, if a large corporation purchased a water cooler for one of its common areas for \$120, the amount could be expensed rather than recorded as an asset even though the cooler will be useful for several years. Materiality is a judgment call. Materiality is concerned with both the dollar amount of an item and/or the nature of an item. It would probably be material if Microsoft received \$1,000,000 in bribes from the Chinese for its technology. A \$1,000,000 write-off of old equipment would probably be immaterial for Microsoft.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 5*  
*Level of Learning: 3*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

161. Give an example of a violation of the stable monetary unit assumption. How would it affect the quality of financial statement information?

In a place or time in which a country experiences severe inflation, this would violate the assumption that dollar amounts are constantly valued. This would limit the usefulness of adding numbers in financial statements, because (for instance) costs at different times are not comparable without adjusting for changes in purchasing power.

*AACSB: Reflective thinking*  
*Blooms: Comprehension*  
*Learning Objective: 6*  
*Level of Learning: 3*

162. Identify or define the following terms: a. periodicity, b. monetary unit.

Periodicity - The life of a company can be divided into artificial time periods to provide timely information to external users.

Monetary unit - In the U.S., financial statement elements should be measured in terms of the U.S. dollar. It assumes that the value of a dollar is stable over time.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 7*  
*Level of Learning: 2*

163. Identify or define the following terms: a. historical cost, b. realization.

Historical cost - Asset and liability measurements should be based on the amount given or received in an exchange transaction.

Realization - Revenue should be recognized only after the earnings process is virtually complete and there is reasonable certainty of collecting the asset to be received from the customer.

*AACSB: Reflective thinking*  
*Blooms: Knowledge*  
*Learning Objective: 7*  
*Level of Learning: 2*

## Chapter 001 Environment and Theoretical Structure of Financial Accounting

164. How does *SFAC No. 157* define fair value?

Fair value is defined as the price that would be received to sell assets or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

*AACSB: Reflective thinking*

*Blooms: Knowledge*

*Learning Objective: 8*

*Level of Learning: 2*

165. Accounting standards have developed over time to reflect changes in the business world as well as changes in our ability to account for such changes. Using the example of marking assets and liabilities to their fair value, explain why you would expect accounting standards to change.

Historically, financial accounting relied on transaction amounts (historical cost) as the fundamental measurement approach for reporting assets and liabilities. As markets have matured, it is more relevant and feasible to report some assets and liabilities at their fair values, particularly if such items have a ready market that is active.

*AACSB: Reflective thinking*

*Blooms: Synthesis*

*Learning Objective: 8*

*Level of Learning: 2*