Intermediate Accounting, Vol 1, 3e **(Lo/Fisher)**
Chapter 1 Fundamentals of Financial Accounting Theory

Learning Objective 1

1) Which statement is NOT correct?
A) Financial accounting is the process of providing information to external parties.
B) Accounting is about the communication of financial information.
C) Accounting is the production of information about an enterprise and the transmission of that information to those who need the information.
D) Financial accounting is the process of providing information to internal parties.
Answer: D
Diff: 1 Type: MC
Skill: Conceptual
Objective: 1.1 Explain the sources of demand and supply of accounting information.

2) How does an accountant decide on the appropriate method of accounting for a business transaction?
A) Evaluating if the particular method is consistent with the conceptual framework.
B) Ensuring that the accounting method agrees with that selected by other companies.
C) Evaluating whether the selected method differs from the underlying economics.
D) Testing the selected method for numerical accuracy and consistency.
Answer: A
Diff: 3 Type: MC
Skill: Conceptual
Objective: 1.1 Explain the sources of demand and supply of accounting information.

3) Which statement is correct?
A) Financial reporting is the process of preparing information for internal parties.
B) Financial reporting involves issuing financial statements to external parties.
C) Financial reporting provides the same information as management accounting.
D) Financial reporting is based on rules issued by the CPA or IASB.
Answer: B
Diff: 1 Type: MC
Skill: Conceptual
Objective: 1.1 Explain the sources of demand and supply of accounting information.

4) Which is NOT a question that financial accounting theory can answer?
A) Why do companies provide financial information to external parties?
B) Why do all companies use the same accounting policies?
C) Why is certain disclosure mandatory in financial reporting?
D) What is the role of financial accounting and reporting?
Answer: B
Diff: 2 Type: MC
Skill: Conceptual
Objective: 1.1 Explain the sources of demand and supply of accounting information.

5) Why is financial information required?
Answer:
• Governmental bodies issue proclamations requiring companies to provide financial information.
• Quasi-governmental organizations issue proclamations requiring companies to provide financial information.
• Accounting organizations such as the CPA or IASB issue proclamations requiring companies to provide financial information.
Diff: 2 Type: ES
Skill: Conceptual
Objective: 1.1 Explain the sources of demand and supply of accounting information.

6) Explain the meaning of financial accounting, managerial accounting and tax accounting. How are these accounting activities related to each other?
Answer: **Financial** reporting is the process by which enterprises provide information to external parties.
Managerial accounting, on the other hand, involves reporting within the enterprise.
Tax accounting is the reporting of taxable amounts to the government revenue authorities.

What ties all the branches of accounting together is the idea that some people have information that others need.
Diff: 1 Type: ES
Skill: Conceptual
Objective: 1.1 Explain the sources of demand and supply of accounting information.

7) Discuss three reasons why it is important to understand accounting theory.
Answer:
• In order to make the best decisions possible, external investors as well as internal managers need to interpret financial and accounting information about the state of the business.
• There is a misunderstanding that accounting standards are simply proclamations issued by government or quasi-governmental regulatory agencies such as the International Accounting Standards Board (IASB) that have no economic benefit to society.
• Rather, financial reporting is an economic good and is therefore subject to the laws of supply and demand. Accounting standards reflect and respond to, although imperfectly, the demand for financial information and the ability of enterprises to supply that information. Financial accounting theory helps us to understand the complexities in the production and consumption (use) of accounting information. Viewed in this way, financial information can be, and is, a subject of rigorous economic analysis.
Diff: 2 Type: ES
Skill: Conceptual
Objective: 1.1 Explain the sources of demand and supply of accounting information.

8) Explain the meaning of generally accepted accounting principles (GAAP).
Answer: GAAP refers to broad principles and conventions of general application as well as rules and procedures that determine accepted accounting practices.
Diff: 2 Type: ES
Skill: Conceptual
Objective: 1.1 Explain the sources of demand and supply of accounting information.

9) Explain the process an accountant uses to determine the appropriate accounting method for a business transaction.
Answer: As GAAP refers to broad principles, not specific rules, accounting involves exercising professional judgment to determine the appropriate accounting. Judgment is exercised by:
• considering the range of possible methods of accounting;
• evaluating whether and how the particular method of accounting is consistent with the conceptual framework underlying GAAP;
• appreciation for the underlying economic forces at work and ensuring that the accounting appropriately reflects the substance of the transaction.
Diff: 3 Type: ES
Skill: Conceptual
Objective: 1.1 Explain the sources of demand and supply of accounting information.

10) Explain what accounting is and why financial reporting exists.
Answer: Accounting is the production of information about an enterprise and the transmission of that information from those who have it to those who need it. In other words, accounting is communicating information about business transactions and activities about business entities to interested external parties.

Financial reporting is the process by which enterprises provide information to external parties. Financial reporting is an economic good that is subject to the laws of supply and demand. Financial reporting exists because interested parties require information about the business entity to make their investment, credit or other decisions. The demand for information arises from people's need to make decisions under uncertainty about the future. In many contexts, there are asymmetric distributions of information amongst people. Those who have more information are the potential suppliers of information to those who have less.
People making decisions under uncertainty demand information to alleviate that uncertainty; an asymmetric distribution of information allows some individuals to supply information to others.
Diff: 2 Type: ES
Skill: Conceptual
Objective: 1.1 Explain the sources of demand and supply of accounting information.

Learning Objective 2

1) Which statement best explains "information asymmetry"?
A) Information asymmetry means that there is uncertainty about the future.
B) Information asymmetry means that some people have more information than others.
C) Information asymmetry means that external parties need financial information.
D) Information asymmetry means information is material to a decision maker.
Answer: B
Diff: 2 Type: MC
Skill: Conceptual
Objective: 1.2 Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.

2) Which statement best explains "moral hazard"?
A) The term refers to a situation where one party has an information advantage over another.
B) The term refers to the need external parties have for financial information.
C) The term refers to the fact that some people have more information than others.
D) The term refers to a situation where one party cannot observe the actions of another party.
Answer: D
Diff: 1 Type: MC
Skill: Conceptual
Objective: 1.2 Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.

3) Which statement best explains "adverse selection"?
A) The term refers to a situation where one party has an information advantage over another.
B) The term refers to the need external parties have for financial information.
C) The term refers to the fact that some people have more information than others.
D) The term refers to a situation where one party cannot observe the actions of another party.
Answer: A
Diff: 1 Type: MC
Skill: Conceptual
Objective: 1.2 Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.

4) Explain the meaning of information and information asymmetry. Give an example of each
Answer: **Information:** Evidence that can potentially affect an individual's decisions. Example: details about the format of the final exam; details about the career placement opportunities for a university's programs; etc.
Information asymmetry: A condition in which some people have more information than others. Example: professor has more information about the final exam than the students; management has more information about the financial results than the shareholders; etc.
Diff: 1 Type: ES
Skill: Conceptual
Objective: 1.2 Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.

5) Explain the meaning of adverse selection and moral hazard. Give an example of each.
Answer: **Adverse selection:** A type of information asymmetry whereby one party to a contract has an information advantage over another party. Examples: buying a resale home; buying a used car; buying shares in a company, etc.
Moral hazard: A type of information asymmetry whereby one party to a contract cannot observe some actions relating to the fulfillment of the contractual terms by the other party. Examples: renting an apartment to a tenant; car insurance; hiring an executive - separation of ownership and management or the principal-agent problem; lending money to a company, etc.
Diff: 1 Type: ES
Skill: Conceptual
Objective: 1.2 Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.

6) Explain the difference between moral hazard and adverse selection.
Answer:
- Moral hazard involves information about one party's actions that is not available to the other party. For this reason, moral hazard is succinctly summed up as *hidden actions*. As actions are involved, moral hazard involves information about what happens in the *future*.
- Adverse selection concerns no actions other than whether the parties choose to reveal information that they possess. Consequently, adverse selection involves *hidden information* from the *past and present* (although such information could have ramifications for the future).

Diff: 2 Type: ES
Skill: Conceptual
Objective: 1.2 Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.

7) Discuss two ways in which a bank can mitigate the problem of moral hazard when lending money to a company.
Answer: The lender can request certain covenants that must be satisfied as a condition of granting the loan; for example, a requirement to have a certain debt-to-equity ratio so that the company does not get over-leveraged. Also, the bank can request an audit report be prepared.
Diff: 2 Type: ES
Skill: Conceptual
Objective: 1.2 Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.

8) Discuss two ways in which a shareholder can mitigate the problem of moral hazard when investing in a company.
Answer: To mitigate this moral hazard problem, audit reports can be used to provide information to owners about the firm's performance as an indirect indicator of management performance.
Compensation can be linked to performance measures such as net income or earnings per share.
Ask management to take partial ownership of the company through stock purchase and stock option programs. The thought being that if managers share in the rewards of their efforts, they will thus be more motivated to create value for the company's owners.
Diff: 2 Type: ES
Skill: Conceptual
Objective: 1.2 Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.

9) Having an audit performed on the company's financial statements BEST illustrates which of the following?
A) Cheap talk.
B) Signalling.
C) Moral hazard.
D) Information.
Answer: B
Explanation: A) Cheap talk refers to communication of unverifiable information by means that are virtually costless.
B) The company needs to use a "signal" (costly signal) to overcome the problem of unverifiable disclosures about the company's financial position and economic performance.
C) Moral hazard represents an asymmetry where one party cannot observe the actions of another.
D) Information asymmetry refers to a situation where one party has more information than another party.
Diff: 2 Type: MC
Skill: Conceptual
Objective: 1.2 Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.

Learning Objective 3

1) Which of the following statements is correct about financial information?
A) All users require the same kind of information.
B) Forward looking information is useful for evaluating management stewardship.
C) Trade offs are necessary in accounting.
D) Historical cost information is useful for pricing the value of a company's shares.
Answer: C
Diff: 2 Type: MC
Skill: Conceptual
Objective: 1.3 Describe the qualitative characteristics of accounting information that help to alleviate adverse selection and moral hazard.

2) How does accounting information help alleviate adverse selection and moral hazard?
Answer:
• The presence of adverse selection reduces outsiders' perception of the value of an enterprise, creating a demand for full disclosure of information that is relevant to the value of the enterprise, and that will help assist them to forecast future cash flows.
• Moral hazard causes outsiders to be suspicious of information supplied by management regarding its actions, creating a demand for information that is reliable and verifiable.
Diff: 1 Type: ES
Skill: Conceptual
Objective: 1.3 Describe the qualitative characteristics of accounting information that help to alleviate adverse selection and moral hazard.

3) Explain how adverse selection and moral hazard affect the qualitative characteristics of accounting information.
Answer: Adverse selection means that users will demand information that is RELEVANT to their decisions.
Moral hazard means that users will demand information that is VERIFIABLE (representationally faithful/reliable) and not prone to manipulation by the preparers.
Diff: 1 Type: ES
Skill: Conceptual
Objective: 1.3 Describe the qualitative characteristics of accounting information that help to alleviate adverse selection and moral hazard.

Learning Objective 4

1) For the situations described below, explain whether managers would be motivated to manage earnings, assets, and equity upward and liabilities downward, or alternatively, managers may be motivated to manage earnings, assets, and equity downward and liabilities upward.

Situation	Management motivation (Upward / Downward)
To influence investors to pay more for the firm's shares.	
To reduce the likelihood of additional taxes or regulations.	
To take a "big bath" in a bad year by recording more expenses than usual so that future years are more likely to show higher and rising profitability, resulting in higher future compensation or stock price.	
To reduce riskiness of its cash flows and obtain funds from the bank at a lower interest rate.	
To obtain a stronger bargaining position in merger negotiations.	

Answer:

Situation	Management motivation (Upward / Downward)
To influence investors to pay more for the firm's shares.	Upward
To reduce the likelihood of additional taxes or regulations.	Downward
To take a "big bath" in a bad year by recording more expenses than usual so that future years are more likely to show higher and rising profitability, resulting in higher future compensation or stock price.	Downward
To reduce riskiness of its cash flows and obtain funds from the bank at a lower interest rate.	Upward
To obtain a stronger bargaining position in merger negotiations.	Upward

Diff: 2 Type: ES
Skill: Conceptual
Objective: 1.4 Evaluate whether and what type of earnings management is more likely in a particular circumstance.

2) For the situations described below, explain whether managers would be motivated to manage earnings, assets, and equity upward and liabilities downward, or alternatively, managers may be motivated to manage earnings, assets, and equity downward and liabilities upward.

Situation	Management motivation (Upward / Downward)
To obtain higher bonuses.	
To increase the likelihood of receiving government subsidies and trade protection.	
To improve bargaining position relative to employee unions.	
To meet covenants based on net income.	
To meet regulatory requirements.	

Answer:

Situation	Management motivation (Upward / Downward)
To obtain higher bonuses.	Upward
To increase the likelihood of receiving government subsidies and trade protection.	Downward
To improve bargaining position relative to employee unions.	Downward
To meet covenants based on net income.	Upward
To meet regulatory requirements.	Upward

Diff: 2 Type: ES
Skill: Conceptual
Objective: 1.4 Evaluate whether and what type of earnings management is more likely in a particular circumstance.

3) Explain how earnings management may arise.
Answer: Insiders have many incentives to manage earnings: to influence share price, to lower the cost of financing, to meet contractual and regulatory requirements, to increase management compensation, to lower political costs, to gain regulatory protection. Most often, the incentives lead to an upward bias in earnings and net assets, but sometimes the incentives lead to a downward bias.
Diff: 1 Type: ES
Skill: Conceptual
Objective: 1.4 Evaluate whether and what type of earnings management is more likely in a particular circumstance.

4) Management motivation to increase the likelihood that the company will receive a $50,000 government rebate BEST illustrates which of the following?
A) Earnings management.
B) Positive accounting theory.
C) Information asymmetry.
D) Efficient securities market.
Answer: A
Explanation: A) Manager's efforts to bias reported accounting information in one way or another is earnings management
B) This is a theory for understanding manager's motivations, accounting choices and reactions to accounting standards
C) Refers to a situation where one party has more information than another party
D) This is a market in which the prices of securities traded in the market at all times properly reflect all information that is publicly known
Diff: 2 Type: MC
Skill: Conceptual
Objective: 1.4 Evaluate whether and what type of earnings management is more likely in a particular circumstance.

Learning Objective 5

1) Which statement appropriately explains the meaning of "publicly accountable enterprise"?
A) Firms without equity, debt or other securities traded in public markets.
B) Firms with equity, debt or other securities traded in public markets.
C) Firms with assets and liabilities that provide goods and services in public markets.
D) New firms entering the public markets to provide goods and services.
Answer: B
Diff: 1 Type: MC
Skill: Conceptual
Objective: 1.5 Explain how accounting information interacts with security markets.

2) Which statement best explains the semi-strong form of the efficient securities market hypothesis?
A) A market in which the prices of securities traded in that market at all times properly reflect all information that is publicly known about those securities.
B) A market in which the prices of securities traded in that market reflect all information, whether publicly or privately known.
C) A market in which the prices of debt securities traded in that market reflect all information that is privately known about those securities.
D) A market in which the prices of equity securities traded in that market reflect all information that is privately known about those securities.
Answer: A
Diff: 1 Type: MC
Skill: Conceptual
Objective: 1.5 Explain how accounting information interacts with security markets.

3) Which statement best explains the relationship between the efficient securities market hypothesis and accounting?
A) Security prices adjust slowly when accounting reports are publicly released.
B) The timeliness of accounting information is irrelevant to securities markets.
C) Accounting information competes with other sources of information.
D) Security prices are unaffected when accounting reports are publicly released.
Answer: C
Diff: 2 Type: MC
Skill: Conceptual
Objective: 1.5 Explain how accounting information interacts with security markets.

4) Why is the efficient securities market hypothesis important for accounting?
A) When providing financial information, management need only consider the specifically identifiable users who they know will rely on the information.
B) Accounting standards can assume that the majority of market participants have a reasonable level of sophistication.
C) Individuals with information that is not publicly available cannot make significant profits.
D) Accounting information is the only source of financial information that markets use.
Answer: B
Diff: 3 Type: MC
Skill: Conceptual
Objective: 1.5 Explain how accounting information interacts with security markets.

5) Explain the meaning of publicly accountable enterprises, efficient securities market (semi-strong form), and efficient securities market (strong form).
Answer:
• Publicly accountable enterprises: Firms with equity, debt, or other securities traded in public markets.
• Efficient securities market (semi-strong form): A market in which the prices of securities traded in that market at all times properly reflect all information that is publicly known about those securities.
• A market that is strong form efficient has prices that reflect all information, whether publicly or privately known.
Diff: 1 Type: ES
Skill: Conceptual
Objective: 1.5 Explain how accounting information interacts with security markets.

6) Explain how accounting information helps security markets?
Answer: Accounting is an important source of information for security markets, and information from security markets is also useful for accounting. The theory of efficient security markets has important implications for the practice of accounting, particularly with regard to the timely provision of information, the need to protect outside investors from insider trading, and the level of sophistication expected of financial statement users.
Efficient market theory has several implications for accounting:
• Security prices react quickly to accounting information – when accounting reports are publicly released, security prices adjust to that information very rapidly.
• Accounting information competes with other sources of information - Because market participants demand all information that is relevant to the pricing of securities, they seek out and use many sources of information in addition to accounting reports. As a result, the demand for accounting reports depends on the ability of these reports to convey information useful for security pricing purposes, incremental to any other information available and in a timely fashion.
• It is important to distinguish new information from what has already been reflected in prices - what may appear to be good news could already have been reflected in a higher share price, so that the stock no longer represents a good buying opportunity.
• Using only publicly available information, it is difficult to earn abnormal profits (i.e. an amount exceeding the expected rate of return given the risk of the investment).
• It is possible to earn abnormal profits using information that is NOT publicly available – individuals who are privy to information that is not publicly available can buy or sell securities at significant profits.
• Accounting reports and standards can assume that users have a reasonable level of sophistication - If publicly traded securities are efficiently priced, it is not necessary for accounting information and accounting standards to be understandable to all potential users. Rather, it is sufficient to ensure that a substantial portion of the market participants are able to process the information for prices to properly reflect that information. The less sophisticated users who have difficulty interpreting accounting (and other) information can rely on market prices.
• Efficient market theory influences legal doctrine - investors need not show direct reliance on information provided by companies in order for them to have a claim against companies and their management for misrepresentation; they merely needed to have relied on the prevailing security price. Thus, management's provision of financial or other information needs to consider not only specifically identifiable users who will rely on that information, but also the overall impact on the security prices and anyone who relies on those prices.
Diff: 2 Type: ES
Skill: Conceptual
Objective: 1.5 Explain how accounting information interacts with security markets.

7) Explain the accounting implications of the following concepts about efficient securities markets:
a) Accounting information competes with other sources of information.
b) Accounting reports and standards can assume that users have a reasonable level of sophistication.
Answer:
a) The demand for accounting reports depends on the ability of those reports to convey decision-useful information for security pricing purposes, incremental to any other information available and in a timely manner. Timeliness is important as evident in the issuance of quarterly financial statements.
b) If publicly traded securities are efficiently priced, it is not necessary for accounting information and accounting standards to be understandable to all potential users. Rather, it is sufficient that they are understandable to a substantial portion of the market participants.
Diff: 3 Type: ES
Skill: Conceptual
Objective: 1.5 Explain how accounting information interacts with security markets.