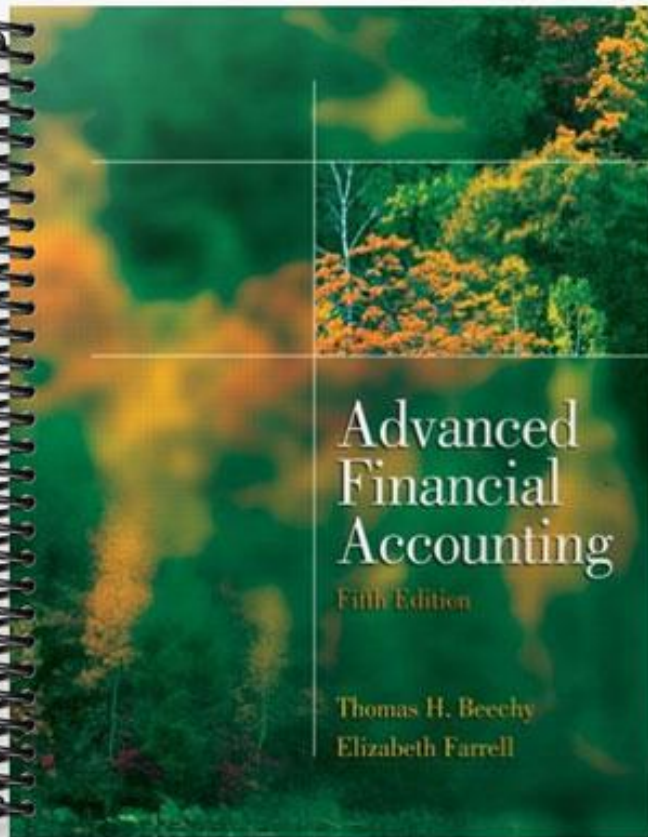


**TEST BANK**



Advanced  
Financial  
Accounting

Fifth Edition

Thomas H. Beechy  
Elizabeth Farrell

# TEST ITEM FILE

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## Advanced Financial Accounting Fifth Edition

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# Chapter 1

## Setting the Stage

### Multiple-Choice Questions

- 1.1 Which of the following statements on professional judgment is false?
- a) The exercise of professional judgment requires the availability of benchmarks or explicit criteria by which to evaluate alternatives.
  - b) The use of professional judgment represents arbitrary behaviour.
  - c) An auditor must use his or her professional judgment to determine whether management's choices are suitable within the context of the company.
  - d) Applying the mandatory disclosure requirements of the CICA Handbook often involves professional judgment.
- b Moderate Page 2
- 1.2 Which of the following statements is true about the use of GAAP in financial reporting?
- a) A private company must follow GAAP when audited financial statements are required.
  - b) A company incorporated under the Canada Business Corporations Act cannot use U.S. dollars as the unit of measure for its year-end financial statements.
  - c) A public company can disregard a specific recommendation of the CICA Handbook where following the Handbook recommendation would result in misleading financial statements.
  - d) A private company must follow GAAP for all financial statements.
- c Moderate Page 13
- 1.3 For which of the following situations would a reporting entity likely use GAAP instead of a disclosed basis of accounting?
- a) A partnership wanting to determine how much capital a retiring partner should receive on her retirement.
  - b) A public company preparing special purpose financial statements with accounting policies dictated by a commercial contract.
  - c) A public company with more than \$10 million of long-term debt.
  - d) A regulated public utility that is subject to regulatory reporting requirements.
- c Moderate Pages 15-19

- .4 Which of the following financial statements would likely be the most effective in conveying information to users that will help them to predict the long-term future cash flows of the company?
- a) A classified balance sheet prepared under the accrual basis of accounting.
  - b) A proforma cash flow statement showing expected cash flows for the next two years.
  - c) A multi-step income statement prepared under the accrual basis of accounting.
  - d) A cash flow statement showing actual cash flows for the past two years.
- c Moderate Pages 5-6
- .5 How do financial analysts refer to earnings that correspond closely to cash flows?
- a) Cash flow per share.
  - b) High quality earnings.
  - c) Earnings determined on a cash basis.
  - d) Low quality earnings.
- b Easy Page 6
- .6 What is often the main motivation behind the practice of taking a “big bath” in a loss year?
- a) To minimize income taxes.
  - b) To smooth income.
  - c) To maximize asset book values.
  - d) To increase future years’ earnings.
- d Easy Page 10
- .7 Financial statements are used as a basis for decisions. One objective not included among “GAAP” user objectives is:
- a) Prediction of future cash flows.
  - b) Compliance monitoring.
  - c) Fraud detection.
  - d) Performance evaluation.
- c Moderate Page 5

- 1.8 Income smoothing is not:
- a) Accomplished through the use of estimates.
  - b) Illegal.
  - c) Under management control.
  - d) Influenced by revenue recognition policies.
- b Moderate Page 11
- 1.9 Accounting harmonization refers to:
- a) The smoothing of income between periods by a company.
  - b) Achieving a high level of consistency among countries' accounting standards.
  - c) All companies using the same accounting standards.
  - d) Accountants learning how to make music.
- b Moderate Page 19
- 1.10 The following is not a requirement for differential reporting:
- a) No publicly traded securities.
  - b) Not in a regulated industry.
  - c) Total assets less than 10 million.
  - d) Unanimous agreement of shareholders.
- c Moderate Page 17
- 1.11 A disclosed basis of accounting excludes:
- a) Exceptions from GAAP.
  - b) Regulatory accounting policies.
  - c) Special purpose reports.
  - d) A reconciliation to GAAP amounts.
- d Moderate Page 18

**Short-Answer Questions**

- 1.12 John Smith is the controller of Excel Co., a private company owned by Rita Cooler. John receives a bonus equal to 10 percent of net income, before the bonus, as calculated in accordance with GAAP.

**Required:**

Explain how John Smith is both the preparer and a user of the financial statements of Excel Co. and whether or not he will likely try to defer income taxes.

**Solution 1.12:**

As the controller, John will likely have primary responsibility for the preparation of the financial statements and will be responsible for the significant choices of many of the accounting policies. He would be regarded as the preparer. However, John receives a bonus that is based on net income, and these financial statements will be used to determine John's bonus. So, John is also a highly interested user of the financial statements.

In order to receive the highest bonus, it is not unreasonable to expect that John would wish to maximize current period net income even if the company must pay higher income tax in the current period. With accounting policy choices that impact on taxable income, John may take action to maximize net income and would be unlikely to be motivated to defer income tax. In other areas, where accounting choices and choices for tax purposes were separate (such as capital cost allowance), John would be expected to attempt to defer income tax.

Moderate Pages 8-10

- 1-13 The Controller of Stress Release Ltd., a small private company, has recently become aware of the new CICA Handbook provisions on Differential Reporting. Having faced opposition from their banker at any time in the past that deviations from GAAP have been suggested, she would like to prepare an "ironclad case" for certain accounting changes made with a view to simplification of the financial reports:

**Required:**

Outline using samples the case for differential reporting in a small private company especially with respect to benefits the banker would agree with.

**Solution 1-13:**

There are several areas where differential reporting may be employed, and these are not considered as deviations from GAAP. As the idea of differential reporting is new in Canadian practice, this may require careful explanation to the banker, who may not previously have encountered this approach and may consider them to be deviations from GAAP.

Students could use a wide variety of approaches to discussion in order to make the case. The seven areas presently candidates for differential reporting are:

- Taxes payable method permissible for reporting income tax.
- Less detailed disclosure required for share capital.
- Less fair value information for financial instruments.
- Certain redeemable preferred shares may be shown as equity, rather than as liabilities.
- Reporting, especially consolidation, of subsidiaries.
- Reporting of significant influence and joint venture investments.
- Goodwill impairment tests.

Moderate Page 17