Understanding Financial Statements 12th edition Fraser Test Bank

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Pearson

Test Questions and Solutions

Chapter 1

True-false

1. A firm's Form 10-K contains only two pieces of information: the financial statements and the notes to the financial statements.

2. One objective of the financial statement user is to determine if an investment would generate attractive returns.

3. The FASB has the authority to set accounting policies for governmental organizations such as the IRS and the SEC has the authority to set accounting policies for corporations.

4. There are three basic financial statements included in corporate annual reports.

5. External auditors are required to audit the internal control assessment of the company as well as the financial statements.

6. Congress passed the Sarbanes-Oxley Act of 2002 in hopes of ending future accounting scandals and renewing investor confidence in the marketplace.

7. The Notes to the Financial Statements are an integral part of the statements and must be read in order to understand the presentation on the face of each financial statement.

8. Information that is significant enough to make a difference in a decision is immaterial.

9. The time period assumption assumes a two-year time frame with interim reporting occurring daily and weekly.

10. GAAP-based financial statements are prepared according to the accrual basis of accounting.

Fill in the Blank

1. The __________ requires all public companies to file a Form 10-K report annually.

2. A corporate annual report contains the following four financial statements: ________________, ________________, ________________, ________________.

3. ______________is responsible for the preparation of the financial statements, including the notes, and the ___________________ attests to the fairness of the presentation.

4. A departure from GAAP in the financial statements will result in the auditor giving a ___________________opinion.

5. The________________________________includes a discussion of the internal and external sources of liquidity.

6. The________________Assumption assumes that business entities will operate indefinitely unless there is strong evidence to the contrary.

7. The cash basis of accounting recognizes _______when cash is received and recognizes _______when cash is paid.

8. The sharper and clearer the picture presented through the financial data and the closer that picture is to financial reality, the higher is the ___________of financial statements and reported earnings.

9. One of the generally accepted accounting principles that provides the foundation for preparing financial statements is the _________ principle.

10. Management exercises control over the budget level and timing of ___________ expenditures.

Multiple Choice

1. What basic financial statements can be found in a corporate annual report?
    a. Balance sheet, auditor's report, and income statement.
    b. Balance sheet, statement of comprehensive income, statement of shareholders' equity, and statement of cash flows.
    c. Earnings statement, statement of retained earnings, balance sheet, and statement of cash outflows.
    d. Income statement, statement of financial position, cash flow statement, and management discussion and analysis.

2. What information can be found on a balance sheet?
    a. Information to support that assets equal liabilities.
    b. The profit or loss for the accounting period.
    c. The financial position on a particular date; i.e. assets, liabilities and shareholders' equity.
    d. The reasons for changes in the cash account.

3. What information can be found on an income statement?
    a. Revenues, expenditures, net profit or loss and net profit or loss per share.
    b. Cash inflows and cash outflows.
    c. A reconciliation of the beginning and ending balances of all revenue accounts.
    d. The financing and investing activities during an accounting period.

4. Which items are required by the SEC to be included in the Form 10-K?
    a. Legal proceedings, three-year summary of financial data, risk factors.
    b. Executive compensation, properties, list of all shareholders by name.
    c. Customer accounts, legal proceedings, financial statements.
    d. Financial statements and supplementary data, properties, risk factors.

5. Where can information about the firm’s accounting policies usually be found?
    a. The auditor's report.
    b. The management discussion and analysis.
    c. Form 8-K.
    d. In the notes to the financial statements.

6. What type of audit report indicates that the financial statements present fairly the financial position, results of operations and the cash flows for the accounting period?

a. A disclaimer of opinion.
b. An unqualified report.
c. A qualified report.
d. An adverse opinion.

7. Which of the following items would not be discussed in the management discussion and analysis?

a. Commitments for capital expenditures.
b. The internal and external sources of liquidity.
c. The market value of all assets.
d. A breakdown of material changes in sales into price and volume components.

8. What organization currently has the legal authority to set accounting policies for the entire world?

a. FASB.
b. IFRS.
c. SEC.
d. None of the above.

9. What is a Form 10-K?

a. The annual report of a publicly held company which must be filed with the SEC.
b. The quarterly report of a publicly held company which must be filed with the SEC.
c. The bankruptcy report of a publicly held company which must be filed with the SEC.
d. The form required to report a change of auditor.

10. Which of the following statements is true?

a. The SEC has delegated accounting rule-making to Congress.
b. The FASB is a public-sector organization.
c. The SEC and FASB have worked closely together in the development of accounting policy.
d. The FASB has legal authority to write international accounting standards.

11. Which of the following statements is false?

a. The auditor is responsible for the preparation of financial statements and the related notes.

b. The Sarbanes-Oxley Act of 2002, Section 404, requires that an internal control report be added to the annual report.

c. The external auditors are required to audit the internal control assessment of the company as well as the financial statements.

d. All of the above.

12. Why is the Management's Discussion and Analysis (MD&A) of interest to the analyst?

a. The MD&A includes a historical description of the firm.

b. The MD&A contains information that cannot be found in the financial data.

c. The MD&A is not of interest to the analyst.

d. The MD&A outlines the executive compensation of the firm.

13. How are revenues and expenses recognized under the accrual basis of accounting?

a. Revenues are recognized when cash is received and expenses are recognized when cash is paid.

b. Revenues and expenses are recognized equally over a twelve month period.

c. Revenues and expenses are recognized based on the choices of management.

d. Revenues are recognized in the accounting period when the sale is made and expenses are recognized in the period in which they relate to the sale of the product.

14. All of the following items should be discussed in the management discussion and analysis except for:

a. Principal accountant fees and services.

b. Anticipated changes in the mix and cost of financing resources.

c. The internal and external sources of liquidity.

d. Unusual or infrequent transactions that affect income from continuing operations.

15. Which of the following is an external source of liquidity?
    a. Sales of services.
    b. Repurchase of stock.
    c. Borrowing.
    d. Sales of products.

16. Which of the following is an internal source of liquidity?
    a. Borrowing.
    b. Sales of stock.
    c. Gifts and donations.
    d. Sales of products or services.

17. In what industry would it be expected that companies would spend a significant amount on research and development activities?
    a. Clothes retailer.
    b. Pharmaceutical.
    c. Groceries.
    d. Wholesale distributor of computer parts.

18. Which of the following items is a discretionary expenditure?
    a. Union wages.
    b. Factory building to produce inventory.
    c. Taxes.
    d. Advertising.

19. What types of information cannot be found in the financial statements?
    a. Reputation of the firm, morale of employees and prestige in the community.
    b. The balance sheet and statement of comprehensive income.
    c. Disclosures about segments of an enterprise.
    d. The statement of cash flows.

20. What item is probably the least useful when analyzing financial statements?
    a. Management discussion and analysis.
    b. Public relations materials.
    c. The statement of cash flows.
    d. The notes to the financial statements.

Short Answer

1. List and describe the four basic financial statements included in a corporate annual report.

2. Write a short essay explaining the following statement: "Unfortunately, there are mazelike interferences in financial statement data that hinder understanding the valuable information they contain."

3. Describe the relationship between the FASB and the SEC.

4. Explain how the timing of the recognition of revenues and expenses can lead to lower quality of reported earnings.

5. Define internal and external sources of liquidity. What is a material deficiency in liquidity? If a firm has a material deficiency in liquidity what should be reported in the management discussion and analysis?

6. What types of information may be missing or hard to find in the financial statements?

7. Explain why the characteristics of comparability and consistency are important in financial reporting?

8. Write an essay discussing the two key principles that are the foundation of the accrual basis of accounting.

Solutions - Chapter 1

True-False

1. F	6. T
2. T	7. T
3. F	8. F
4. F	9. F
5. T	10. T

Fill in the Blank

1. SEC
2. Balance sheet, income statement or comprehensive income statement, statement of stockholders' equity, statement of cash flows
3. Management, auditor
4. Qualified
5. Management Discussion and Analysis
6. Going Concern
7. Revenues, expenses
8. Quality
9. Matching
10. Discretionary

Multiple Choice

1. b	6. b	11. a	16. d
2. c	7. c	12. b	17. b
3. a	8. d	13. d	18. d
4. d	9. a	14. a	19. a
5. d	10. c	15. c	20. b

Short Answer

1. The balance sheet shows the financial position—assets, liabilities, and stockholders' equity—of the firm on a particular date, such as the end of a quarter or a year.

The income statement presents the results of operations—revenues, expenses, net profit or loss and net profit or loss per share—for the accounting period. Also required is a statement of comprehensive income immediately following the income statement or a combined statement of comprehensive income that includes information presented in both the income statement and the statement of comprehensive income.

The statement of shareholders' equity reconciles the beginning and ending balances of all accounts that appear in the shareholders' equity section of the balance sheet.

The statement of cash flows provides information about the cash inflows and outflows from operating, financing, and investing activities during an accounting period.

2. The following items make it more difficult for a user of financial statements to understand the financial data:

- Quantity of information
- Clean audit reports do not mean the firm will not fail
- Complex accounting policies that may be confusing
- Accounting rules are constantly changing
- Management has discretion in presenting financial information
- Some information is not available or is difficult to find in the financial statements

3. The FASB and the SEC work closely together in the development of accounting policy, with the SEC playing largely a supportive role. Pressures from the private sector have caused controversy at times. Congress has given accounting rulemaking authority to the SEC, who, in turn, has passed that role to the FASB. The SEC maintains veto power over any rule written by the FASB. Reporting companies must use the rules written by both the SEC and the FASB and if these companies do not like the rules, they will most likely lobby their congressmen to force the SEC to change those rules.

4. Generally accepted accounting principles require that expenses be matched with the generation of revenue in order to determine net income for the accounting period. This matching process involves judgments by management regarding the timing of revenue and expense recognition. If management chooses to record revenues or expenses earlier or later than they should be recorded, lower quality of earnings will result.