Western Governors University (WGU) ACCT3650 D105 Intermediate Accounting III Practice Exam (Sample)

Study Guide

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Questions

1. Which circumstance requires a company to disclose changes in accounting principles?

   A. Changes in management

   B. Changes in financial performance

   C. Changes in accounting principles

   D. Changes in assets

2. What defines a provision in accounting?

   A. A liability with a fixed amount

   B. A liability of uncertain timing or amount

   C. An asset that generates revenue

   D. An equity account

3. Which of the following types of securities are considered trading securities?

   A. Long-term bonds

   B. Debt and equity securities for short-term sale

   C. Real estate investments

   D. Retirement funds

4. What eventual effect might the IRS's regulations have on financial statements?

   A. Increased profit margins for companies

   B. A change in liability preparation and recording

   C. An impact on tax obligations reported in statements

   D. A simplified process for expense reporting

5. How do companies report changes in estimates?

   A. Retrospectively

   B. Prospectively

   C. Only through financial disclosures

   D. By adjusting prior year financial statements

6. In financial statements, what does non-controlling interest represent?

A. Value of assets owned directly by the parent

B. Ownership interests in a subsidiary not owned by the parent

C. Debt obligations of the parent company

D. Common stock held by the parent

7. Cash payments for settling debts fall under which category of cash flows?

A. Operating activities

B. Investing activities

C. Financing activities

D. Equity activities

8. Where should Paiva Inc. report the cumulative effect of a change in inventory valuation?

A. Income statement as a gain

B. Retained earnings statement as a deduction

C. Balance sheet as an adjustment to assets

D. Footnotes to financial statements

9. When a company changes the useful life of an asset, when does this change necessitate an adjustment?

A. Only in the current period

B. Only in future periods

C. In the current period and future periods

D. Retrospectively to past periods only

10. What is the definition of arbitrage in finance?

A. The purchase of high-risk investments

B. The simultaneous sale and purchase of an asset for profit

C. The evaluation of future cash flows

D. The strategy to hold assets for long periods

Answers

1. C
2. B
3. B
4. C
5. B
6. B
7. C
8. B
9. C
10. B

Explanations

1. Which circumstance requires a company to disclose changes in accounting principles?

   A. Changes in management

   B. Changes in financial performance

   C. Changes in accounting principles

   D. Changes in assets

The need for a company to disclose changes in accounting principles arises specifically when there are actual changes in the accounting methods used for financial reporting. Such changes might occur due to the adoption of new accounting standards or a decision to change from one accepted accounting method to another that provides more reliable or relevant financial information. Disclosing these changes is essential because it allows stakeholders to understand the context of the financial statements, enhances transparency, and ensures comparability across financial periods. The users of financial statements—such as investors, creditors, and analysts—rely on consistent accounting methods to evaluate a company's financial health and performance accurately. Understanding this requirement helps stakeholders grasp the effects of different accounting choices made by the company, which may impact the financial results and positions presented. Also, it assures confidence in the integrity of the financial reporting process, aligning with the broader principle of full disclosure in financial reporting.

2. What defines a provision in accounting?

   A. A liability with a fixed amount

   B. A liability of uncertain timing or amount

   C. An asset that generates revenue

   D. An equity account

A provision in accounting is defined as a liability of uncertain timing or amount. This means that while the obligation exists and must be recognized, the exact timing of the payment or the amount that will eventually be required is not known with certainty. This uncertainty is what distinguishes a provision from other types of liabilities that have fixed amounts or due dates. Provisions are often recognized for situations such as pending lawsuits, warranty obligations, or restructuring costs, where the company is reasonably certain that an obligation exists but cannot precisely quantify the financial impact. Recognizing provisions helps ensure that financial statements provide a more accurate depiction of a company's financial health and obligations, adhering to the conservatism principle in accounting, which aims to avoid overstatement of income or assets. In contrast, the other choices describe aspects that do not align with the definition of a provision. For instance, a liability with a fixed amount is a straightforward obligation with known terms, whereas an asset that generates revenue and an equity account refer to entirely different categories within accounting. These distinctions clarify why the correct answer prominently focuses on the uncertainty around the timing or amount associated with provisions.

3. Which of the following types of securities are considered trading securities?

A. Long-term bonds

B. Debt and equity securities for short-term sale

C. Real estate investments

D. Retirement funds

Trading securities refer specifically to debt and equity securities that a company intends to buy and sell within a short time frame to earn profits from market price fluctuations. These securities are actively managed, meaning that the purchases and sales are intended for near-term profit rather than long-term investment. The correct choice is thus focused on those debt and equity securities that are held with the intent of selling them in the near term. This distinguishes them from other types of investments such as long-term bonds, which are typically held until maturity, or real estate investments and retirement funds, which are intended for long-term holding and growth rather than immediate trading for profit. By this definition, debt and equity securities for short-term sale fit within the classification of trading securities as they align with the purpose of trading rather than holding for investment or income generation over a longer period.

4. What eventual effect might the IRS's regulations have on financial statements?

A. Increased profit margins for companies

B. A change in liability preparation and recording

C. An impact on tax obligations reported in statements

D. A simplified process for expense reporting

The reasoning behind the selection of the impact on tax obligations reported in financial statements as the correct response rests on the role that IRS regulations play in shaping how companies report their income tax liabilities. IRS regulations often establish frameworks for how tax obligations should be calculated, recognized, and presented in financial statements. When the IRS introduces new regulations or updates existing ones, these rules can lead to changes in how companies assess their tax liabilities. This, in turn, affects the amounts reported in financial statements. For instance, if there is a change in the allowable deductions or tax credits under new IRS regulations, it could result in either an increase or decrease in the tax expense for a company in a given period. This manipulation of tax-related figures will directly influence not only the tax obligations reported but also the net income figures presented in the financial statements. This understanding is crucial because financial statements aim to present a true and fair view of a company's financial position. Any significant change in tax obligations, due to new IRS regulations, must be communicated accurately to stakeholders, affecting how the financial performance of a company is perceived. In contrast, while increased profit margins, changes in liability preparation and recording, and simplified expense reporting might be considered effects of various regulatory or accounting practices, they do not

5. How do companies report changes in estimates?

A. Retrospectively

B. Prospectively

C. Only through financial disclosures

D. By adjusting prior year financial statements

When companies experience changes in estimates, they adopt a prospective approach. This means that the effects of the change are applied to the financial statements starting from the period of the change going forward, rather than adjusting or restating prior periods' financial statements. For instance, if a company revises its estimate of warranty expenses or the useful lives of fixed assets, the new estimates will influence the amounts recognized in subsequent periods but not alter the financial results of past periods. This approach is consistent with the accounting principle that financial statements should reflect the economic conditions and circumstances as they are currently understood, rather than attempting to look back and adjust prior reports for estimates that were made based on the information available at that time. The other options focus on retrospective adjustments or disclosures, but such methods are not applicable for changes in estimates, which distinguishes them from changes in accounting principles or errors that would warrant prior period restatements.

6. In financial statements, what does non-controlling interest represent?

A. Value of assets owned directly by the parent

B. Ownership interests in a subsidiary not owned by the parent

C. Debt obligations of the parent company

D. Common stock held by the parent

Non-controlling interest represents the ownership interests in a subsidiary that are not owned by the parent company. This concept arises when a parent company has a controlling interest in a subsidiary (typically more than 50% of the voting shares) but does not own 100% of the subsidiary. The non-controlling interest accounts for the portion of equity in the subsidiary that belongs to other shareholders. Including non-controlling interest in the consolidated financial statements is important because it provides a complete picture of the financial positioning and performance of the entire corporate group. It reflects the rights of those shareholders outside of the parent company and is shown in the equity section of the balance sheet. For clarity and context, ownership interests in assets directly owned by the parent (which would be referred to directly here) does not encompass the portion owned by external shareholders in a subsidiary, nor do debt obligations or stock held specifically by the parent company relate to this concept.

7. Cash payments for settling debts fall under which category of cash flows?

A. Operating activities

B. Investing activities

C. Financing activities

D. Equity activities

Cash payments for settling debts are categorized as financing activities because they relate directly to the way a company finances its operations and growth through debt. Financing activities include transactions that involve obtaining resources from creditors or repaying those obligations. When a company makes cash payments to pay off loans or other debts, it is effectively managing its financial structure and obligations. This classification is important because it helps users of financial statements understand how a company is managing its debts and its overall financial strategy. It reflects the cash transactions that influence the company's long-term liabilities, which are crucial for assessing its capital structure and financial health. The other categories involve different aspects of cash flows: operating activities relate to the core revenue-generating activities of the company, investing activities encompass the purchase and sale of long-term assets, and equity activities pertain to transactions involving equity and shareholders' equity. Therefore, the correct categorization of debt settlement payments in cash flow statements is as financing activities.

8. Where should Paiva Inc. report the cumulative effect of a change in inventory valuation?

A. Income statement as a gain

B. Retained earnings statement as a deduction

C. Balance sheet as an adjustment to assets

D. Footnotes to financial statements

The cumulative effect of a change in inventory valuation is reported in the retained earnings statement as a deduction. This treatment aligns with the principle of retrospective application for accounting changes under generally accepted accounting principles (GAAP). When a company changes its inventory valuation method—for instance, shifting from FIFO to LIFO—it must adjust prior financial statements to reflect this change as if it had always used the new method. This adjustment affects retained earnings because it reflects prior periods' profit calculations that have now been altered due to the new inventory valuation method. The cumulative effect typically involves subtracting (or adding) the adjusted amount to the opening balance of retained earnings in the statement. This presentation ensures the financial statements accurately show the impact of accounting changes on the company's financial position. Other options do not represent how the change should be recognized. For instance, recognizing it as a gain in the income statement would incorrectly suggest that the change immediately impacts profits, while reporting it on the balance sheet as an adjustment to assets would not adequately communicate the retroactive nature of the adjustment required for retained earnings. Additionally, while footnotes to financial statements are important for providing context and details about the change, they do not serve as the primary method for reflecting the financial impact on the retained earnings statement based on

9. When a company changes the useful life of an asset, when does this change necessitate an adjustment?

A. Only in the current period

B. Only in future periods

C. In the current period and future periods

D. Retrospectively to past periods only

When a company changes the useful life of an asset, it necessitates an adjustment in both the current period and future periods. This is because a change in the useful life affects the depreciation expense calculation going forward, necessitating a reevaluation of how the asset is being depreciated based on its new expected useful life. In the current period, the company must update the depreciation expense to reflect the asset's revised useful life, which can lead to immediate adjustments in the financial statements for that period. This ensures that the financial statements accurately represent the asset's current value and expense recognition. For future periods, the depreciation expense needs to be recalculated for remaining useful life based on the new estimate. This ongoing adjustment ensures that the asset's cost is allocated over the appropriate period, reflecting its remaining economic benefits to the company. Past periods do not require adjustments to prior financial statements, as accounting practices typically do not allow for retrospective changes for estimates unless an error has occurred. Thus, the focus remains on adjusting current and future financial statements to reflect the new circumstances.

10. What is the definition of arbitrage in finance?

A. The purchase of high-risk investments

B. The simultaneous sale and purchase of an asset for profit

C. The evaluation of future cash flows

D. The strategy to hold assets for long periods

Arbitrage in finance refers to the simultaneous sale and purchase of an asset in different markets to take advantage of price discrepancies. This practice allows traders to secure risk-free profit by exploiting differences in asset prices. For example, if an asset is priced lower on one exchange and higher on another, a trader can buy on the exchange with the lower price and sell on the one with the higher price at the same time. This ensures that the profit is locked in without any market risk involved. The other options describe different financial activities but do not accurately define arbitrage. Purchasing high-risk investments does not capture the essence of taking advantage of pricing inefficiencies across markets. Evaluating future cash flows is a crucial part of investment analysis and valuation, but it does not align with the immediate buy-sell action inherent in arbitrage. Holding assets for long periods is a long-term investment strategy and also does not relate to the concept of simultaneously engaging in transactions for profit based on price differences.