LO.a: Distinguish between financial reporting quality and quality of reported results (including quality of earnings, cash flow, and balance sheet items).

1. The information provided by a high quality financial report will *least likely:*
   A. contain information that is relevant, neutral, and free from error.
   B. decrease company value.
   C. help in assessing the earnings quality of a firm.

2. High quality financial reports *least likely* reflect:
   A. decision-useful information.
   B. earnings smoothing.
   C. accounting compliant with a standard such as GAAP or IFRS.

3. Low earnings quality *most likely* indicate:
   A. deviation from accounting standards.
   B. information that is not decision-useful to assess a company's performance.
   C. activities that are not sustainable in the future.

4. Aggressive accounting choices in a period of good performance is an example of:
   A. Low reporting quality and low earnings quality.
   B. High reporting quality and low earnings quality.
   C. High reporting quality and high earnings quality.

5. Reporting higher than actual operating cash flow during a period is *least likely* an example of:
   A. aggressive accounting.
   B. conservative accounting.
   C. low reporting quality.

6. Which of the following is an example of aggressive accounting choice?
   A. Increase the amount of debt reported on the balance sheet in the current period.
   B. Decrease the operating cash flow in the current period.
   C. Increased earnings in the current period.

7. High-quality financial reports will *most likely*:
   A. indicate earnings are sustainable.
   B. indicate earnings are not sustainable.
   C. provide information that faithfully represents the economic reality of the company.

LO.b: Describe a spectrum for assessing financial reporting quality.

8. Which of the following is a hindrance in the proper evaluation of a company's past performance?
   A. Low earnings quality.
   B. Low financial reporting quality.
   C. Both low earnings quality and low financial reporting quality.

9. Which of the following results in the lowest level of financial reporting quality?
   A. Non-compliant accounting.
   B. Within GAAP but biased choices.
   C. Within GAAP but managed earnings.

10. Which of the following companies will *least likely* have the highest financial reporting quality?
    A. A company that combines the results of the two segments it operates in: healthcare and retail.
    B. A company that reports good performance due to favorable exchange rate movement.
    C. A company that provides delayed reports, but ones that are GAAP-compliant and decision-useful.

11. Which of the following *best* describe the characteristics at the top of the quality spectrum of financial reports?
    A. GAAP, decision-useful and unsustainable earnings.
    B. GAAP, decision-useful, sustainable earnings with adequate returns.
    C. GAAP-complaint with biased accounting choices.

12. Which quality is *best* represented by the quality spectrum of financial reports?
    A. Financial reporting.
    B. Earnings.
    C. Both.

LO.c: Distinguish between conservative and aggressive accounting.

13. If a particular accounting choice is considered conservative in nature, then the financial performance for the current period would *most likely*:
    A. be non-compliant.
    B. exhibit an upward bias.
    C. exhibit a downward bias.

14. Which of the following is *most likely* to reflect aggressive accounting choices?
    A. Increased reported earnings in later periods.
    B. Increased reported earnings in the current period.
    C. Decreased reported earnings in the current period.

15. A company is experiencing a period of difficult financial performance. In order to exceed analysts' earnings forecasts in the current reporting period, the company would *least likely* use:
    A. aggressive revenue recognition in the current period.
    B. aggressive expense recognition in the current period.
    C. conservative expense recognition in the current period.

16. Both IFRS and US GAAP require the oil and gas industry to recognize revenue after the product is shipped and extraction costs to be expensed when incurred. This can be *best* described as:
    A. an aggressive accounting approach.
    B. a conservative accounting approach.
    C. a non-biased accounting approach.

17. Not recognizing the increase in the market prices of gold in inventory until it is sold, is an example of:
    A. conservative accounting.
    B. aggressive accounting.
    C. standard accounting.

18. Assume the accounting standard requires a cost to be expensed. Instead, if the cost is capitalized, then the current-period reports will *most likely* be :
    A. unbiased.
    B. biased upward.
    C. biased downward.

LO.d: Describe motivations that might cause management to issue financial reports that are not high quality.

19. Which of the following conditions *least likely* results in poor financial reporting quality?
    A. Motivation.
    B. Rationalization.
    C. Opportunity cost

20. Which of the following situations will *least likely* motivate managers to inflate earnings in the current period?
    A. Potential disciplinary action.
    B. Exceeding analysts' earnings forecasts.
    C. The manager's compensation is tied to stock price performance.

21. One of the reasons to understate earnings in the current period is *least likely* to:
    A. have earnings surprises in the future periods.
    B. hide poor performance.
    C. avoid unwanted political attention.

22. Which of the following is a reason for issuing low quality reports in a period of good performance for a company with low leverage?
    A. Avoiding debt covenant violation.
    B. Indifferent to political attention.
    C. Inadequate internal systems.

23. A manager would be motivated to issue high quality financial reports if:
    A. his marketing strategy paid off and revenues improved significantly.

B. his compensation was linked to stock performance.
C. he is worried working for a company with poor performance will limit his future career opportunities.

24. A manager will *least likely* be motivated to overstate earnings in the current period:
    A. to exceed previous year's earnings.
    B. to beat market expectations in a period of poor performance.
    C. to enhance reputation among competitors.

LO.e: Describe conditions that are conducive to issuing low-quality, or even fraudulent, financial reports.

25. Which of the following *best* describes a motivation for management to issue low-quality financial reports?
    A. Ineffective board of directors.
    B. Justifying a biased accounting choice.
    C. Need to maintain a minimum interest coverage ratio of 3.0 as required by the loan agreement with the bank.

26. Which of the following can *least likely* be perceived as an opportunity for issuing low-quality financial reports?
    A. Inadequate internal controls.
    B. Accounting standards that give room for judgement and to make an inappropriate choice.
    C. Pressure to meet a revenue target.

LO.f: Describe mechanisms that discipline financial reporting quality and the potential limitations of those mechanisms.

27. Management commentaries in a company's financial reports are *most likely* intended to:
    A. ensure that rules have been followed.
    B. provide a description of principle risks.
    C. assure that financial information is presented fairly.

28. Which of the following is *least likely* a limitation of an audit opinion?
    A. The financial information is provided by the company.
    B. To provide assurance that the information complies with a set of accounting standards.
    C. It is based on sampling of the financial reports.

29. The purpose of an audit opinion is *most likely:*
    A. to provide assurance that the financial statements are fairly presented.
    B. to detect fraud.
    C. to identify misstatements and rectify them.

30. A private company takes a loan from a bank to purchase an equipment. The company later increases the estimated useful life of an equipment during the year, which decreases the depreciation expense. What is the *most* appropriate mechanism to ensure that the financial reporting quality is not compromised because of this change?
    A. A private contract with the bank with debt covenant.
    B. Claiming compliance with the applicable accounting standard.
    C. Getting an audit opinion to provide assurance that the change is justified.

31. The securities of Cog Corp., a company based in Kundu, trade in the United States. The financial reports of Cog are prepared in accordance with IFRS. Which of the following is *not* sufficient as per SEC?
    A. A reconciliation to US GAAP must be provided.
    B. An opinion on internal control's effectiveness must be provided as part of audit opinion.
    C. An audit opinion assuring that the reports are presented fairly, comply with Kundu law, and is in accordance with IFRS is sufficient.

LO.g: Describe presentation choices, including non-GAAP measures that could be used to influence an analyst's opinion.

32. To increase performance in the current period, a manager would *least likely*:
    A. defer expenses to later periods.
    B. defer current income to a later period.
    C. report liabilities at lower values.

33. To increase performance in a later period, a manager would *most likely*:
    A. Use nonrecurring transactions.
    B. Recognize revenue prematurely.
    C. Recognize expenses prematurely in current period.

34. A company prepares financial statements that depart from generally accepted accounting principles. In this case it can be said that:
    A. financial reporting quality is low and earnings quality is difficult to determine.
    B. financial reporting quality is difficult to determine and earnings quality is low.
    C. financial reporting quality is difficult to determine and the earnings quality is high.

35. A non-GAAP measure:
    A. may be used in earnings releases.
    B. may not be used to describe solvency position in management, discussion, and analysis.
    C. may exclude infrequent or unusual items that are likely to occur again.

LO.h: Describe accounting methods (choices and estimates) that could be used to manage earnings, cash flow, and balance sheet items.

36. A company wishing to decrease earnings in the current period may choose to:

A. capitalize an asset purchase.
B. lower provision for bad debts.
C. decrease the useful life of fixed assets.

37. Biases in revenue recognition would *most likely* be suspected if a firm:
A. understates expenses.
B. reports higher revenue relative to the previous period.
C. uses bill and hold revenue recognition.

38. Which of the following is *least likely* an area of concern in revenue recognition for analysts?
A. Revenue is recognized upon delivery of goods.
B. Bill and hold transactions.
C. Free on board shipping point on the last day of the quarter.

39. A company wishing to increase earnings in future periods will *least likely*:
A. choose double-declining depreciation.
B. expense a payment instead of capitalizing.
C. choose straight-line depreciation.

40. An indicator of poor earnings quality is *most likely*:
A. Operating cash flow greater than net income.
B. Net income substantially greater than operating cash flow.
C. Operating cash flow of a company close to the benchmark.

LO.i: Describe accounting warning signs and methods for detecting manipulation of information in financial reports.

41. Which of the following would *most likely* suggest that there are problems in company's accrual accounting? If cash flow to net income ratio is consistently:
A. equal to 1.
B. less than 1.
C. greater than 1.

42. Which of the following observations made by an analyst *most likely* reduces the quality of earnings of the company? The company:
A. reported for the first time an asset titled "Deferred customer acquisition costs."
B. has reduced its estimate of the expected useful life of computer equipment from 8 years to 5 years.
C. entered into long-term leases for its manufacturing equipment instead of purchasing it and recorded the leases as capital leases.

43. Which of the following is *most likely* to be a warning sign of low quality earnings?
A. Smaller use of operating leases than peer companies.
B. Use of a lower discount rate in pension plan assumptions.
C. A ratio of operating cash flow to net income smaller than 1.0.

44. Relative to its competitors, a company may be recognizing revenue prematurely if its:
    A. days sales outstanding is decreasing.
    B. receivables turnover is decreasing.
    C. asset turnover is decreasing.

Solutions

1. B is correct. A high quality financial report increases company value, and contain information that is relevant and free from error.

2. B is correct. High quality financial reports have decision-useful information and are compliant with accounting standards such as GAAP or IFRS. Earnings smoothing is the result of biased accounting choices and low reporting quality.

3. C is correct. Low earnings quality reflects activities that are not sustainable in the future. The other two are characteristics of low reporting quality.

4. A is correct. Aggressive accounting implies that the reported numbers are not consistent with the economic reality of the company; hence the reporting quality is low. Aggressive accounting leads to high earnings numbers which are not sustainable. Consequently, the earnings quality is also low.

5. B is correct. Higher than actual operating cash flow, inflated revenues are examples of aggressive accounting.

6. C is correct. Increased earnings in future periods is an example of conservative accounting.

7. C is correct. High-quality financial reports provide information that faithfully represents the economic reality of the company.

8. B is correct. Low financial reporting quality is a hindrance in the proper evaluation of a company's past performance.

9. A is correct. Under the quality spectrum of financial reports, non-compliant accounting is at the lowest level among the given options.

10. A is correct. Assessing the profitability of each segment is difficult if they are combined. This is an example of biased accounting choice.

11. B is correct. Unsustainable earnings represent low earnings quality, which is below the top of the spectrum. Biased accounting choices are at the middle of the quality spectrum.

12. C is correct. Quality spectrum represents both financial reporting and earnings. At the top of the spectrum is high financial reporting and high earnings quality. At the bottom, is low financial reporting and low earnings quality.

13. C is correct. If a particular accounting choice is considered conservative in nature, then the financial performance for the current period would exhibit a downward bias.

14. B is correct. Accounting choices are considered aggressive if they increase the company's reported performance and financial position in the current period.

15. C is correct. In order to exceed analysts' earnings forecasts in the current reporting period, the company might try to use aggressive revenue and expense recognition. Aggressive expense recognition implies decreasing the amount of expenses reported in the period.

16. B is correct. Recognizing expenses as incurred and revenues only after the product is shipped is an example of conservatism.

17. A is correct. Accounting standards allow companies to reflect commodities at market value. Not reflecting the increase in market value of a commodity such as gold is an example of conservatism.

18. B is correct. Aggressive accounting choices result in financial reports to be biased upward.

19. C is correct. Three conditions result in poor financial reporting quality: opportunity, motivation and rationalization.

20. A is correct. Potential disciplinary actions will prohibit managers from inflating earnings in the current period

21. B is correct. One of the motivations for aggressive accounting choices is to hide poor performance.

22. C is correct. A is incorrect because the company has low leverage, so avoiding debt covenant is unimportant considering the performance is also good. B is incorrect because being indifference to political attention is not a reason for issuing low quality reports. C is correct because inadequate internal systems might lead to low quality financial reports.

23. A is correct. The other two are motivations for a manager to manipulate earnings.

24. C is correct. Concealing poor performance especially if compensation is tied to the company's earnings, and enhancing reputation among customers and suppliers is likely to motivate managers to inflate earnings. Enhancing reputation among competitors is not a criteria.

25. C is correct. Inefficient board of directors presents an opportunity whereas justifying a biased accounting choice is rationalizing for issuing a low-quality financial reports.

26. C is correct. Pressure to meet a revenue target is an example of motivation: one of the three conditions conducive to issuing low-quality reports. The other two are examples of opportunities.

27. B is correct. Management commentaries in a company's financial reports are intended to provide a description of the principle risks.

28. B is correct. This is a function of an audit opinion and not a disadvantage.

29. A is correct.

30. C is correct. An audit opinion will assure the reasonableness of the change in the estimated useful life.

31. C is correct. Statements A and B are mandatory as per SEC.

32. B is correct. A manager would defer current income to a later period to increase future performance.

33. C is correct. The other two actions will increase performance in current period.

34. A is correct. If a company's financial statements depart from GAAP it can be said that the financial reporting quality is low and earnings quality is difficult or impossible to determine.

35. A is correct. Items that may occur again cannot be eliminated when using a non-GAAP measure.

36. C is correct. If a company wants to decrease reported earnings, the company's managers may reduce the useful life of fixed assets.

37. C is correct. Bill and hold method of revenue recognition may result in a bias in revenue recognition

38. A is correct. The other two are red flags for early revenue recognition that analysts must be aware of.

39. C is correct. The double-declining method results in lower earnings in the initial periods and higher earnings in later periods. Similarly, expensing rather than capitalizing results in lower earning initially but higher earnings later. Hence a company which wants to increase earnings in the future is likely to use options A and B but less likely to use option C.

40. B is correct. This is an indicator of accounting manipulation to increase net income.

41. B is correct. If cash flow to net income is consistently less than 1, there may be problems in the company's accrual accounting.

42. A is correct. An asset such as "deferred acquisition costs" indicates the amount is not expensed in the current period. This causes earnings to be unsustainably high in the current

period which is an indication of low earnings quality. Options B and C will cause the earnings to be lower in the current period.

43. C is correct. A ratio of operating cash flow to net income below 1.0 can be a warning sign of low quality earnings.

44. B is correct. Decreasing receivables turnover, increasing asset turnover and increasing days sales outstanding are signs of recognizing revenue prematurely.