Financial Reporting and Analysis: Quality of Financial Reports and Financial Statement Analysis

Test ID: 7440516

Question #1 of 84

Question ID: 462513

Holdall Corporation recently reclassified many of their assets such that the average useful life of their depreciable assets was reduced. Which of the following is the *most likely* result from this change on net income and inventory turnover? (Assume everything else remains constant.) Net income will:

✗ **A)** **decrease and inventory turnover will rise.**

✗ **B)** increase and inventory turnover will not change.

✓ **C)** decrease and inventory turnover may or may not change.

Explanation

Depreciation expense increases as the depreciable life of an asset decreases. Thus, net income will decline. Depreciation will only affect inventory turnover if depreciation has been allocated to individual inventory items; when and why this happens is outside the scope of the Level II curriculum.

Question #2 of 84

Question ID: 462511

A firm seeking to lower current tax liability may elect to use which method of inventory valuation during an inflationary period?

✓ **A)** **LIFO.**

✗ **B)** FIFO.

✗ **C)** Average cost.

Explanation

During a inflationary period, using LIFO would increase COGS, since the most recent (highest cost) inventory would be sold. Therefore, earnings and taxes would be lowest under LIFO.

Question #3 of 84

Question ID: 462498

Jeremy Jennings is explaining the concept of earnings quality to his new colleagues. Which of the following measures is *most* indicative of a higher quality of earnings when attempting to forecast future earnings?

✗ **A)** **Higher level of earnings.**

✗ **B)** Higher degree of conservatism of earnings.

✓ **C)** Higher degree of persistence of earnings.

Explanation

The term earnings quality usually refers to the persistence and sustainability of a firm's earnings; that is, more persistent and sustainable earnings are considered higher quality.

Measuring earnings quality based on conservative earnings is an inferior measure when attempting to forecast future earnings because most accruals will self-correct over time. For example, the lower earnings that result from accelerated depreciation will increase in the later years of the asset's life. Focusing on accruals and deferrals is a more effective way of measuring earnings quality.
A higher level of earnings has no impact on increasing the quality of earnings since the former may be derived largely from earnings manipulation on the part of management.

Question #4 of 84

Question ID: 462495

With regard to specific measures to analyze in detecting manipulation in the financial reporting process, which of the following statements is the *least* accurate?

✓ **A)** **A decreasing days' sales outstanding (DSO) measure may be an indication of lower quality revenue.**

✗ **B)** Negative nonrecurring or non-operating items may be indicative of misclassifying an operating expense.

✗ **C)** An increasing days' inventory on hand (DOH) measure may be indicative of obsolete inventory.

Explanation

Days' sales outstanding (DSO) measures the number of days it takes to convert receivables into cash and is calculated by dividing the number of days in the period by the accounts receivable turnover ratio. An increasing DSO (decreasing receivables turnover) may be an indication of lower quality revenue; that is, the longer it takes to collect from customers, the more likely the receivables will turn into bad debt.

Days' inventory on hand (DOH) is equal to the number of days in the period divided by inventory turnover ratio and it measures the number of days it takes to sell inventory. An increasing DOH may be indicative of obsolete inventory.

Analysts should compare changes in the core operating margin over time and look for negative nonrecurring (e.g., restructuring charges, asset impairments, and write-downs) or non-operating items that occurred when the ratio increased. This may be the result of misclassifying an operating expense.

Question #5 of 84

Question ID: 462526

Due to a change in accounting standards, TRK Construction's QSPE must now be consolidated. The QSPE has purchased, TRK's accounts receivables and had financed those with notes payables. Assume that TRK's current ratio before consolidation is 1.10. Consolidation will *most likely* result in which of the following:

✗ **A)** **an increase in the current ratio.**

✗ **B)** no change in the current ratio.

✓ **C)** a decrease in the current ratio.

Explanation

The correct treatment for consolidation of the QSPE would be an increase in current assets (accounts receivable) and in current liabilities (notes payable) by the same amount. If the current ratio is greater than one, consolidation would decrease the current ratio.

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Question ID: 462480

The following information pertains to Morley Inc. (Morley) and Crowell Inc. (Crowell) for 2007 and 2008:

Accrual Ratio	**2008**	**2007**
Morley	16.1%	14.7%
Crowell	6.9%	8.5%

Based on the information provided, which of the following conclusions about the two companies is *most* appropriate?

✓ **A) Crowell's earnings quality is higher than Morley's.**

✗ **B)** Morley's earnings quality is higher than Crowell's.

✗ **C)** Crowell's earnings quality is deteriorating compared to Morley's.

Explanation

Crowell's earnings quality is higher because its accrual ratio is lower in both years. Furthermore, Crowell's earnings quality is also improving (due to the decrease in its accrual ratio) while Morley's is deteriorating (due to the increase in its accrual ratio).

Question #7 of 84

Question ID: 472492

Aggressive revenue recognition practices are *least likely* to increase:

✗ **A) reported expenses**

✗ **B)** reported assets

✓ **C)** reported ending inventory

Explanation

Aggressive revenue recognition practices would increase accounts receivable, revenues, expenses, income and stockholder's equity. Ending inventory would decline but by less than the increase in accounts receivable resulting in increase in total assets. Early recognition of revenues also accelerates recognition of expenses (COGS).

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Question ID: 472508

Samuel Maskin, CFA is evaluating the financial statements of Northern Energy Inc. The following is an extract from Northern's cash flow statement for the past three years:

	20x6	**20x5**	**20x4**
Net Income	$1,023	$988	$744
Depreciation	$187	$145	$128
Restructuring Charges	$(108)	$(104)	$212
Accounts receivable	$(172)	$(145)	$(33)
Inventories	$(418)	$(202)	**$(180)**

Accounts Payable	$38	$37	$33
OCF	$550	$719	$904

The restructuring charges for Northern has most likely:

✓ **A) Reduced reported earnings in 20x4 while increasing reported earnings in 20x5 and 20x6.**

✗ **B)** Increased reported earnings for 20x4 while reducing reported earnings in 20x5 and 20x6.

✗ **C)** Increased reported earnings in 20x6 while reducing reported earnings in 20x4 and 20x5.

Explanation

Restructuring charges contribute positively to 20x4 cash flow indicating that it was a non-cash charge against that year's income. In the following two years, there is a reversal of that charge leading to an artificial increase in reported earnings for 20x5 and 20x6.

Question #9 of 84

Question ID: 462514

Star Chemical Inc. (SCI) reported the following year-end data:

Depreciation expense	$25 million
Net income	$35 million
Dividends	$10 million
Total assets	$250 million
Shareholder's equity	$195 million
Effective tax rate	35 percent

SCI also reported that it changed from an accelerated depreciation method to straight line depreciation. The change resulted in a decrease in depreciation expense of $5 million. Management felt that the change "would not have a material effect on financial performance measures." Ignoring deferred taxes, what are the return on assets (ROA) and return on equity (ROE) measures under the old depreciation methods?

✓ **A) ROA is 12.96% and ROE is 16.56%.**

✗ **B)** ROA is 13.30% and ROE is 17.05%.

✗ **C)** ROA is 13.50% and ROE is 17.51%.

Explanation

The change in depreciation methods results in net income increasing by $3.25 million ($5 million × (1-0.35)) and total assets increasing by $5 million. Without the change in depreciation methods SCI would have reported:

Depreciation expense	$30 million	($25 + $5)
Net income	$31.75 million	($35 - $3.25)
Total assets	$245 million	($250 - $5)
Shareholder's equity	$191.75 million	($195 − $3.25)

Note that assets would have been lower by $5 million due to the accelerated depreciation and equity would be lower by $3.25 million ($5 × (1 − 0.35)) due to lower retained earnings. In order to balance the $5 million reduction in assets, equity will fall by $3.25 million and tax liabilities will fall by $1.75 million. Therefore, ROA would have been 12.96% ($31.75 / $245) and ROE would have been 16.56% ($31.75 / $191.75).

Question #10 of 84

Question ID: 414656

Joe Carter, CFA, believes Triangle Equipment, a maker of large, specialized industrial equipment, has overstated the salvage value of its equipment. This would:

- ✗ **A) overstate liabilities.**
- ✓ **B)** overstate earnings.
- ✗ **C)** understate earnings.

Explanation

Overstating the salvage value reduces depreciation expense, which in turn increases earnings.

Question #11 of 84

Question ID: 462536

An analyst finds return-on-equity (ROE) a good measure of management performance and wants to compare two firms: Firm A and Firm B. Firm A reports net income of $3.2 million and has a ROE of 18. Firm B reports income of $16 million and has an ROE of 16.

A review of the notes to the financial statements for Firm A, shows that the earnings include a loss from smelting operations of $400,000 and that the firm has exited this business. In addition, the firm sold the smelting equipment and had a gain on the sale of $300,000.

A similar review of the notes for Firm B discloses that the $16 million in net income includes $2.6 million gain on the sale of no longer needed office property. Assume that the tax rate for both firms is 36%, and that the notes describe pre-tax amounts. Which of the following is *closest* to the "normalized" ROE for Firm A and for Firm B, respectively?

- ✗ **A) 16.0 and 18.0.**
- ✗ **B)** 17.1 and 16.9.
- ✓ **C)** 18.4 and 14.3.

Explanation

The ROE for Firm A is adjusted for the \$400,000 loss on discontinued operations and the \$300,000 non-recurring gain. The ROE for Firm B is adjusted to remove the effects of the \$2.6 million one-time gain.

The first step in this problem is to solve for equity using ROE. Then, "normalize" net income by adjusting for discontinued operations and non-recurring items. Then, solve for "normalized" ROE.

Firm A:
$18\% = 3{,}200{,}000 / \text{Equity}_A$
$\text{Equity}_A = 17{,}777{,}778$ (rounding)
$\text{Normalized Net Income}_A = 3{,}200{,}000 + (1 - 0.36)(400{,}000 - 300{,}000)$
$\text{Normalized ROE}_A = 3{,}264{,}000 / 17{,}777{,}778 = 18.360\%$

Firm B:
$16\% = 16{,}000{,}000 / \text{Equity}_B$
$\text{Equity}_B = 100{,}000{,}000$
$\text{Normalized Net Income}_B = 16{,}000{,}000 + (1 - 0.36)(-2{,}600{,}000)$
$\text{Normalized ROE}_B = 14{,}336{,}000 / 100{,}000{,}000 = 14.336\%$

18.360 and 14.336 are *closest* to 18.4 and 14.3

Question #12 of 84

Question ID: 462510

Inventories are listed on the balance sheet at \$600,000, retained earnings are \$1.9 Million. In the notes to financial statements, you find a LIFO reserve of \$125,000. Also, the probability of a LIFO liquidation is high. Assuming a tax rate of 36%, what will be the adjusted value of retained earnings?

✗ **A)** **\$1,855,000.**
✓ **B)** \$1,980,000.
✗ **C)** \$1,820,000.

Explanation

The highly probably LIFO liquidation suggests net income, income tax expense, and equity will rise. The analyst can make this adjustment now for forecasting purposes. The adjustment to retained earnings will be: \$125,000 × (1 − 0.36).

Question #13 of 84

Question ID: 472506

Which of the following is *least likely* an indicator of high-quality cash flow?

✓ **A)** **Total cash flow that is positive and high.**
✗ **B)** OCF adequate to cover capital expenditures, dividends and debt repayments.
✗ **C)** OCF derived from sustainable sources.

Explanation

High-quality cash flow focuses on positive, adequate and sustainable *operating* cash flow. Firms with high borrowings could have high total cash flow but such cash flows would not be sustainable (nor considered high-quality).

Question #14 of 84

Question ID: 462481

Costiuk Inc. (Costiuk) saw a large increase in its net operating assets (NOA) over the year. During the year, it also reported a number of nonoperating revenues and deferred revenues. Which of the following statements regarding Costiuk's increase in NOA and the most likely item to self-correct is *most* accurate?

	Increase in NOA	Most likely item to self-correct
✗ A)	**suggests lower earning quality**	**nonoperating revenues**
✓ B)	suggests lower earning quality	deferred revenues
✗ C)	suggests higher earning quality	nonoperating revenues

Explanation

Deferrals and accruals are most likely to self-correct.

The large increase in net operating assets is indicative of a high accruals ratio as demonstrated by the following equation:

$\text{Accruals}^{BS} = \text{NOA}_{END} - \text{NOA}_{BEG}$

$$\text{Accruals Ratio}^{BS} = \frac{(\text{NOA}_{END} - \text{NOA}_{BEG})}{\left[\frac{\text{NOA}_{END} + \text{NOA}_{BEG}}{2}\right]}$$

In interpreting the ratio, the higher the ratio, the lower the earnings quality.

Nonrecurring and nonoperating revenues do not typically self-correct like deferrals and accruals, thereby providing a greater manipulation benefit to the firm.

Question #15 of 84

Question ID: 414657

Analyst Jane Kilgore is worried that some of Maxwell Research's accrual accounting practices will lead to excessive operating earnings recognition in the near-term. Examples of Kilgore's concerns include the following:

- Accelerated revenue recognition of service agreements.
- Classification of recurring revenue as nonrecurring revenue.
- Understated inventory obsolescence.

Which of Kilgore's concerns is *least* likely to overstate current operating earnings?

✗ A) **Understated inventory obsolescence.**

✓ B) Classification of recurring revenue as nonrecurring revenue.

✗ C) Accelerated revenue recognition of service agreements.

Explanation

Classification of recurring revenue as nonrecurring revenue will *understate* current operating earnings. The other two items act to overstate revenue and understate expenses.

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Question ID: 462517

A firm has booked as a sale, the transfer of $100 million in short-term accounts receivable to Public Finance Co., subject to recourse. The notes to the financial statements disclose that as of the end of the fiscal year, $80 million remained uncollected. In order to reflect this on the balance sheet, which of the following adjustments must be made?

✗ **A)** **Decrease retained earnings and increase accounts receivable.**

✓ **B)** Increase accounts receivable and increase current liabilities.

✗ **C)** Decrease cash and increase accounts receivable.

Explanation

Since the accounts receivable were sold with recourse, the risk on uncollected accounts remains with the company.

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Question ID: 462492

De Freitas Inc. (De Freitas) is a conglomerate. Its computer division was very profitable in the current year because it launched a successful new lightweight laptop computer. Prices in the automobile division have been rising over the years but it is engaged in a LIFO liquidation in the current year. Which of the following best describes the effect on the long-run earnings of the computer division and the automobile division compared to the most recent year?

	Computer division earnings	Automobile division earnings
✗ **A)**	**Decrease**	**Increase**
✓ **B)**	Decrease	Decrease
✗ **C)**	Increase	Decrease

Explanation

When examining earnings, analysts should be aware that earnings at extreme levels tend to revert back to normal levels over time. This phenomenon is known as mean reversion. For example, capital is attracted to successful projects (i.e. the new laptop) thereby increasing competition and *decreasing* earnings in the long-run.

A LIFO liquidation involves selling more goods than are replaced. Thus, the automobile division penetrated the older, lower cost layers of inventory thereby increasing profit. This higher profitability is not sustainable, however, because the firm will eventually run out of lower priced inventory. In the long-run, the earnings will *decrease* (to normal levels).

Question #18 of 84

Question ID: 462503

An analyst is developing a framework for financial statement analysis for his firm. The primary goal of financial statement analysis is to:

✓ **A) facilitate an economic decision.**

✗ **B)** justify trading decisions for purposes of the Statement of Code and Standards.

✗ **C)** document portfolio changes for purposes of the Prudent Investor Rule.

Explanation

The primary goal of financial statement analysis is to facilitate an economic decision. For example, the firm may use financial analysis to decide whether to recommend a stock to its clients. Documentation and justification of trading decisions may be aided by financial statement analysis, but these are not the primary purposes.

Question #19 of 84

Question ID: 472490

To assess the quality of financial reports, which question is *least* necessary for an analyst to answer?

✓ **A) Are reported earnings consistent with the firm's budget?**

✗ **B)** Do earnings represent an adequate level of return?

✗ **C)** Are the financial reports decision useful and GAAP compliant?

Explanation

Quality of financial reports is assessed by answering two questions: Whether the financial reports are decision useful and GAAP compliant and whether the results quality is high (i.e., earnings provide adequate return on capital and are sustainable).

Question #20 of 84

Question ID: 462509

Express Delivery Inc. (EDI) reported the following year-end data:

Depreciation expense	$30 million
Net income	$30 million
Total assets	$535 million
Shareholder's equity	$150 million
Effective tax rate	35 percent

Last year EDI purchased a fleet of delivery vehicles for $140 million. For the first year, straight-line depreciation was used assuming a depreciable life of 7 years with no salvage value. However, at year-end EDI's management determined that assumptions of a useful life of 5 years with a salvage value of 10 percent of the original value were more appropriate. How would the return on assets (ROA) and return on equity (ROE) for last year change due to the change in depreciation assumptions? ROA and ROE would be *closest to*:

✗ **A) ROA 5.7% and ROE 19.5%.**

✗ **B)** ROA 5.3% and ROE 20.5%.

✓ **C)** ROA 5.0% and ROE 18.2%.

Explanation

The reported ROA and ROE are 5.6% (30/535) and 20.0% (30/150) respectively. Under the new depreciation assumptions, depreciation expense would be (140-14)/5 = 25.2 million. Under the original assumptions depreciation of the fleet was 20 million. Therefore depreciation increases by 5.2 million. With the change in depreciation methods EDI would have reported:

Depreciation expense	$35.20 million	(30 + 5.2)
Net income	$26.62 million	(30 − (5.2 × (1-0.35)))
Total assets	$529.80 million	(535 − 5.2)
Shareholder's equity	$146.62 million	(150 − 3.38)

Note that assets would have been lower by $5.2 million due to the new depreciation assumptions and shareholder's equity by $3.38 million (5.2 × (1 − 0.35)) due to lower retained earnings. Tax liabilities would have fallen by $1.82 million to balance the $5.2 million reduction in assets. Therefore, ROA would have been 5.0% (26.62 / 529.80) and ROE would have been 18.16% (26.62 / 146.62).

Question #21 of 84

Question ID: 462524

Consider the following statements:

Statement 1:	Compared to the cash basis of accounting, the accrual basis of accounting provides more timely information about future cash flows.
Statement 2:	Compared to the cash basis of accounting, the accrual basis requires more use of discretion than the cash basis.

Are these statements CORRECT?

✓ **A) Yes.**

✗ **B)** No, because it is actually the cash basis of accounting that provides more timely and relevant information to users about future cash flows.

✗ **C)** No, because it is actually the cash basis of accounting that results in more difficulty in properly assigning revenues and expenses to the appropriate periods.

Explanation

Users of financial information seek timely information about future cash flows. The accrual basis of accounting provides this information at the earliest appearance of objective evidence. Thus, accrual accounting provides more timely and relevant information to users. The cash basis is more concerned with recording cash flows for transactions that have already occurred.

Accrual accounting (not cash-based accounting) necessitates the use of discretion because of the many estimates and judgments involved with assigning revenue and expense to the appropriate periods.

Question #22 of 84

Question ID: 414668

Junior analyst Xander Marshall sends an e-mail to his boss, Janet Jacobs, CFA, suggesting that Peterson Novelties is manipulating its results to artificially inflate profits. He cites four reasons for his conclusion:

- The LIFO reserve is declining.
- Earnings are much higher in the September quarter than in other quarters.
- Many nonoperating and nonrecurring gains are being recorded as revenue.
- Much of Peterson's earnings come from equity investments not reflected on the cash-flow statement.

Jacobs is less concerned about Peterson's earnings than Marshall is, though she does resolve to check out one of his concerns. Which of Marshall's observations *best* supports his conclusion?

✓ **A)** **Equity investment earnings not reflected on the cash-flow statement.**

✗ **B)** The declining LIFO reserve.

✗ **C)** Nonoperating and nonrecurring gains recorded as revenue.

Explanation

On its own, a declining LIFO reserve is not a sign of fraud. Peterson Novelties could have simply moved a lot of inventory and disclosed the LIFO liquidation in its footnotes. When unusual gains are recorded as revenue they will artificially boost sales growth. Each of the above issues are potential danger signs, but can also be easily explained in a manner beyond reproach. However, earnings from equity investments that do not generate cash flow are of very low quality and warrant further examination.

Question #23 of 84

Question ID: 462491

Complete the following sentence. The cash component of income is ____________ than the accrual component.

✗ **A)** **the same persistence.**

✓ **B)** more persistent.

✗ **C)** less persistent.

Explanation

The accrual component of income (accruals) is less persistent than the cash component. By persistent we mean the income is sustainable; that is, a dollar of earnings today implies a dollar of earnings in future periods. Lower persistency is partially due to the estimates involved with accrual accounting.

Question #24 of 84

Question ID: 462535

Endrun Company reported net income of $4.7 million in 1999, and $4.3 million in 2000. In reviewing the annual report an analyst notices that the Endrun took a charge of $2.4 million in 1999 for the costs of relocating its main office, and in 2000 booked a gain of $900,000 on the sale of its previous office building. What would "normalized earnings" be for 1999 and 2000 if we assume a tax rate of 36% for both years?

✗ **A)** **$7.1 million and $5.2 million.**

✗ **B)** $3.99 million and $2.54 million.

✓ **C)** $6.236 million and $3.724 million.

Explanation

You will increase 1999 earnings by the tax-adjusted value of the 2.4 million one-time charge (2.4 × (1 - 0.36) = +1.536), and you would decrease Y2000 earnings by the tax-adjusted amount of the $0.9 million one-time gain (0.9 × (1 - 0.36) = -0.576).

Questions #25-26 of 84

George Edwards is a senior analyst with The Edge Group, an independent equity research firm specializing in micro cap companies that have recently had an initial public offering, or are likely to go public within the next three years. Over the current market cycle, small company stocks have been the leading performers in the equity market, and micro cap money managers have had huge cash inflows due to their funds' strong performance. With an excess amount of cash and few good investment opportunities due to the high valuations in the marketplace, fund managers have turned to independent research firms like The Edge Group to help them discover new investment ideas.

With a large number of mutual fund managers asking them for research reports, business at The Edge Group is booming. To help handle the large amount of business, Edwards has hired two new junior analysts, Paul Kelley and Rachael Schmidt. Both Kelley and Schmidt have degrees in finance, and came highly recommended to Edwards.

In Kelley and Schmidt's orientation meeting, Edwards told them that what has made The Edge Group successful in delivering quality research to its clients is its willingness to dig into company financial statements and not take the accounting numbers at face value. Every item in the financial statements should be scrutinized and adjusted if necessary. Edwards tells the new analysts that if there is one lesson they should learn, it is that "there is a difference between accounting reality and economic reality."

For their first assignment, Edwards has asked the new analysts to put together a draft of a research report on Landesign, an architecture firm specializing in landscape design for municipalities, residential developments, and wealthy individuals. The firm also sells various kinds of stone and plastic products which are used in landscaping applications. Edwards tells the new analysts that he will help put together the report, but he would like them to do a majority of the legwork.

Since it was founded seven years ago, Landesign has grown at an annual rate exceeding 20%. Much of the growth comes from Landesign's acquisitions of regional competitors. Edwards points out to the analysts that Landesign used purchase method accounting. Kelley, looking to impress Edwards with his knowledge, tells him that when one company acquires another, assets of both companies are restated to fair market value, and that higher depreciation can lead to lower quality earnings. Not wanting to be outdone, Schmidt adds that liquidity measures such as the quick ratio and the cash ratio should improve as Landesign makes acquisitions.

Kelley decides to review Landesign's 2004 financial statements and make notes about significant accounting practices being used. His notes are shown in the exhibit below:

> Exhibit 1: Kelley's Notes on Landesign's Accounting Practices
>
> - The firm uses First In, First Out (FIFO) accounting. As a side note, the current inflation rate has remained relatively constant at an annual rate of 3%.
> - Equipment and office furniture are depreciated based on the 200% declining balance method.
> - Fixed assets (equipment) are generally assigned short useful life estimates.
> - The expected return on defined benefit pension plan assets is 2 to 3 percentage points below the long-term rate of return for similar assets.
> - Landesign reports deferred taxes of $350,000 for 2004, compared with $300,000 and $280,000 in deferred taxes for

2003 and 2002, respectively.

Schmidt notices that the footnotes to Landesign's financial statements include a reference to an agreement to receive a minimum amount of stone used to construct landscape walls from a supplier. Under the terms of the agreement, Landesign will pay for the stone whether it is used in the current accounting period or not. The agreement allows Landesign to pay a price that is significantly less than the current market price for similar quality stone.

A second footnote indicates that Landesign has an eight-year rental commitment for a greenhouse used to grow plants and store mulch that Landesign uses in the landscaping process. On the financial statements, $55,000 in rent expense for the greenhouse is listed on the income statement. The footnote also states that the $55,000 rental expense payment was agreed upon with Fred's Nursery, the owner of the greenhouse, based upon an interest rate of 7%.

A third footnote indicates that Landesign has sold its accounts receivable to Dais Enterprises for 95% of their original value of $130,000. The footnote indicates that Landesign retains the risk of noncollection of the receivables.

The final footnote on the page indicates that Landesign has a revolving line of credit at which it can borrow funds in the future at an interest rate of 6%.

After going through the information, Kelley and Schmidt discuss their findings and start to work on their report for Edwards.

Question #25 of 84

Question ID: 462507

Which of the following items noted in Kelley's Notes on Landesign's Accounting Practices would *least* likely be considered indicators of high earnings quality. Landesign's use of:

✗ A) **the 200% declining balance method of depreciation on its furniture and equipment.**

✓ B) FIFO accounting in a mildly inflationary economy.

✗ C) short useful life estimates for fixed assets.

Explanation

High earnings quality is established by a clear and conservative approach to stating earnings. Even though inflation is relatively mild, FIFO accounting will result in lower cost of goods sold (COGS), and higher net income. This is more aggressive than the use of Last In, First Out (LIFO) method. Short useful lives for fixed assets, use of accelerated depreciation, and using a conservative estimate for returns on pension assets will all tend to increase expenses and are examples of conservative accounting practices.

Question #26 of 84

Question ID: 462508

Which of the following adjustments should Schmidt make to Landesign's financial statements to account for the greenhouse that Landesign uses to grow plants and store mulch?

✓ A) **Increase both liabilities and assets by $341,500.**

✗ B) Increase both liabilities and assets by $328,400.

✗ C) Increase liabilities and decrease equity by $440,000.

Explanation

The rental agreement for the greenhouse is an operating lease and essentially represents off-balance sheet financing. To adjust Landesign's balance sheet for the operating lease, Schmidt needs to capitalize the lease by increasing both liabilities and assets by the present value of the lease payments. The interest rate used in the present value computation is the lower of the firm's financing rate or the rate implicit in the lease. We are told that the rental payments of $55,000 are based on an interest rate of 7%. However, we are told in another footnote that Landesign expects to be able to borrow funds in the future at a rate of 6%. We therefore use the lower firm financing rate of 6% in our computation. The present value of the lease payments is: N = 8; I/Y = 6%; PMT = -55,000; FV = 0; CPT PV = $341,539.

Question #27 of 84

Question ID: 456302

Samson Therapeutics records all leases as operating leases. Compared to recording capital leases, this results in lower:

- ✗ **A) inventory.**
- ✗ **B)** expenses.
- ✓ **C)** leverage.

Explanation

Finance (capital) leases are recorded on the balance sheet, and by recording all leases as operating leases, the company can reduce its leverage. Lease accounting has no effect on inventory. "Expenses" is not the best answer as operating leases will result in higher expenses in the later years relative to the finance (capital) lease.

Question #28 of 84

Question ID: 462512

Millennium Airlines Corp. (MAC) reported the following year-end data:

Rent expense	$24 million
Depreciation expense	$17 million
EBIT	$88 million
Interest expense	$22 million
Total assets	$500 million
Long-term debt	$150 million
Capital lease obligations	$100 million
Total equity	$250 million

MAC also reported that the present value of its operating leases at the beginning of the year was $128 million at 10% interest rate. The term on the leases was 8 years. Ignoring taxes, what are the effects on the leverage (liabilities / total capital) and times interest earned if an analyst chooses to capitalize the leases using a straight-line depreciation (zero salvage, life = lease term) assumption? Leverage measures:

- ✗ **A) increase to 65% from 50% and times interest earned decreases to 1.78 times from 4 times.**
- ✗ **B)** remain unchanged and times interest earned decreases to 1.78 times from 4 times.
- ✓ **C)** increase to 60% from 50% and times interest earned decreases to 2.76 times from 4 times.

Explanation

Using the reported data the leverage measure is 0.50 ((150 + 100) / (150 + 100 + 250)) and times interest earned is 4 times (88 / 22). Following the capitalization of the operating leases the balance sheet values are:

Total assets	$612 million	(500 assets + 128 leases - 16 depreciation on leases)
Value of operating leases	$116.80 million	(Ending Lease liability = 128 Beg lia + 12.8 Int - 24 Rent payment)
Long-term debt	$150 million	unchanged
Capital lease obligations	$100 million	unchanged
Total equity	$245.2 million	(250 + 24 rent payment − 16 dep − 12.8 interest)

Therefore, the leverage measure is 0.60 ((116.80 + 150 + 100) / (116.8 + 150 + 100 + 245.2)).

The income statement is affected in the following way:

reported EBIT	88	
+ rent expense	24	
= EBIT excluding cost of operating leases	112	
- depreciation of operating leases	16	($128 million/8 years)
= adjusted EBIT	96	

Interest expense will increase by $12.8 million ($128 million × 0.10) to $34.8 million. Therefore times interest earned decreases to 2.76 times (96 / 34.8). Recall that when capitalizing operating leases interest expense is calculated as the present value of the lease obligations multiplied by implied interest rate.

Question #29 of 84

Question ID: 462482

Fero Inc. (Fero) is a successful computer consulting services firm that has an established policy of investing its excess cash in short-term, virtually riskless, and highly liquid money market securities. However, it has recently deviated from this policy by investing in commercial paper and medium-cap domestic equities. As well, Fero entered into a $1.0 million lease with Pasquale Inc. (Pasquale) for some specialized computer equipment on December 28, 2008 that will be shipped at the very start of its next fiscal period on January 1, 2009. In exchange for the lease, Fero agrees to provide consulting services to Pasquale. Which of the following activities is one in which Fero is *least* likely involved?

✗ **A) Misclassifying cash flow.**

✗ **B)** Ignoring cash flow.

✓ **C)** Managing cash flow.

Explanation

Fero is ignoring cash flow, most likely misclassifying cash flow, but there is no evidence that Fero is managing cash flow. Firms can misrepresent their cash generating ability by misclassifying investing activities as operating activities and vice versa. For example, under U.S. GAAP, the cash flow statement reconciles the changes in cash and cash equivalents. Cash equivalents include short-term, highly liquid investments. Some firms park cash in longer-term investments such as marketable debt and equity securities. Typically, the acquisition and disposal cash flows from these longer-term investments are reported as investing activities in the cash flow statement.

Noncash investing and financing activities are not reported in the cash flow statement since they do not result in an inflow or outflow of cash. For example, a capital lease is both an investing and financing decision in that the transaction is the equivalent of borrowing the purchase price. However, since no cash is involved, the transaction is not reported (it is *ignored*) on the cash flow statement throughout the life of the lease.

Question #30 of 84

Question ID: 462494

Holding everything else constant, the existence of which of the following items will *most likely* result in direct cash inflows or outflows for a firm in the future?

✗ **A)** **Deferred expenses.**

✗ **B)** Unearned revenue.

✓ **C)** Accrued expenses.

Explanation

Accrued expenses are expenses that have been incurred but not yet paid. For example, a firm may recognize wage expense in one period but actually pay the wages in a later period. In this case, when the expense is recognized in the income statement, a liability is increased on the balance sheet (i.e., wages payable). When the wages are paid, the liabilities decrease as does the firm's cash (cash outflow occurs in the future).

Unearned (deferred) revenue occurs when payment is received in advance of providing goods or services. Unearned revenue is reported as a liability on the balance sheet. Once the revenue is earned, the liability decreases. For example, a magazine subscription is usually paid in advance. When received, the publisher increases its cash and records a liability for its obligation to deliver (cash inflow occurs now). Once delivery occurs, revenue is recognized and the liability decreases.
Deferred expenses are costs that will benefit future periods. These costs usually involve noncurrent assets and prepaid assets. For example, a tenant must usually pay his rent in advance. The result is a decrease in the tenant's cash and an increase in a prepaid asset (cash outflow occurs now). Once the rent expires, expense is recognized and the asset decreases.

Questions #31-36 of 84

Hatfield Industries is a large manufacturing conglomerate based in the United States with annual sales in excess of $300 million. Its shares are traded on the New York Stock Exchange, and have a market capitalization of nearly $750 million. Hatfield is currently under investigation by the Securities and Exchange Commission (SEC) for accounting irregularities and possible legal violations in the presentation of the company's financial statements. A due diligence team from the SEC has been sent to Hatfield's corporate headquarters in Philadelphia for a complete audit in order to further assess the situation.

Several unique circumstances at Hatfield are discovered by the SEC due diligence team during the course of the investigation:

- Management has been involved in ongoing negotiations with the local labor union, of which approximately 40% of its full-time labor force are members. Labor officials are seeking increased wages and pension benefits, both of which Hatfield's management states is not possible at this time due to decreased profitability and a tight cash flow situation. Labor officials have accused Hatfield's management of manipulating the company's financial statements in order to have a reason to not grant any concessions during the course of negotiations.
- All new equipment obtained over the past several years has been established on Hatfield's books as operating leases, although past acquisitions of similar equipment was nearly always classified as capital leases. Financial statements of industry peers indicate that capital leases for this type of equipment are the norm. The SEC wants Hatfield's management to provide justification for this apparent deviation from "normal" accounting practices.
- Inventory on Hatfield's books has been steadily increasing for the past few years in comparison to sales growth.

Management credits improved operating efficiencies in its production methods that have contributed to boosts in overall production. The SEC is seeking evidence that Hatfield somehow may have manipulated its inventory accounts.

The SEC due diligence team is not necessarily searching for evidence of fraud, but possible manipulation of accounting standards for the purpose of misleading shareholders and other interested parties. Initial review of Hatfield's financial statements indicates that at a minimum, certain practices have resulted in low quality earnings.

Question #31 of 84

Question ID: 462474

Labor officials believe that the management of Hatfield is attempting to understate its net income in order to avoid making any concessions in the labor negotiations. Which of the following actions is *least likely* to be employed by management in an attempt to avoid making concessions to the union?

- ✗ **A) Recognizing revenue at the time of delivery rather than when payment is received.**
- ✓ **B)** Lengthening the life of depreciable assets in order to lower the depreciation expense.
- ✗ **C)** Lowering the discount rate used in the valuation of the company's pension obligations.

Explanation

It is unlikely that management would lengthen the life of depreciable assets in order to extract concessions from the union, as lengthening the depreciable life of an asset would boost earnings results. (Study Session 7, LOS 23.d)

Question #32 of 84

Question ID: 462475

Hatfield has begun recording all new equipment leases on its books as operating leases, a change from its consistent past use of capital leases. What is the *most likely* motivation behind Hatfield's change in accounting methodology? Hatfield is attempting to:

- ✓ **A) improve its leverage ratios and reduce its perceived leverage.**
- ✗ **B)** increase its operating margins relative to industry peers.
- ✗ **C)** reduce its cost of goods sold and increase it profitability.

Explanation

Off balance-sheet financing through the use of operating leases is acceptable when used appropriately. However, companies can use them too aggressively in order to reduce their perceived leverage. A comparison among industry peers and their practices may indicate improper use of accounting methods. (Study Session 7, LOS 23.d)

Question #33 of 84

Question ID: 462476

The SEC due diligence team is searching for the reason behind Hatfield's inventory build-up relative to its sales growth. One way to identify a deliberate manipulation of financial results by Hatfield is to search for:

- ✗ **A) receivables that are growing faster than sales.**
- ✓ **B)** a decline in inventory turnover.
- ✗ **C)** a delay in the recognition of expenses.

Explanation

A warning sign of accounting manipulation is abnormal inventory growth as compared to sales growth. By overstating inventory, the cost of goods sold is lower, leading to higher profitability. (Study Session 7, LOS 23.f)

Question #34 of 84

Question ID: 462477

Which of the following findings is *most likely* to be an indicator of potential revenue quality issues?

- ✓ **A) Large increases in trade receivables.**
- ✗ **B)** Reduction in volatility of the ratio of revenue to cash collection.
- ✗ **C)** Lessor use of the operating lease classification.

Explanation

Revenue quality issues may be indicated by large increases in accounts receivable or large decreases in unearned revenue, an *increase* in the volatility of the ratio of revenue to cash collections, and by lessor use of capital leases (Study Session 7, LOS 23.f)

Question #35 of 84

Question ID: 462478

The accruals ratio can *most accurately* be computed as the:

- ✗ **A) change in net operating assets divided by 2.**
- ✓ **B)** change in net operating assets divided by average net operating assets.
- ✗ **C)** cash flow from operating activities minus cash flow from investing activities.

Explanation

Accruals ratio can be computed as change in net operating assets divided by average net operating assets. (Study Session 7, LOS 23.e)

Question #36 of 84

Question ID: 462479

Which of the following is *least likely* to be an indicator of improper accounting to boost operating performance?

- ✗ **A) Classification of ordinary expenses as nonrecurring.**
- ✗ **B)** Deferral of expenses by capitalizing.
- ✓ **C)** Decreases in core operating margin accompanied by spikes in negative special items.

Explanation

Classification of ordinary expenses as nonrecurring and deferral of expenses via capitalization would improve reported operating margins as would *increases* in core operating margin accompanied by spikes in negative special items. (LOS 23.f)

Question #37 of 84

Question ID: 462531

An investor relations spokesperson for the Square Door Corporation was quoted as saying that Square Door shares were a bargain, selling at a price-to-earnings (P/E) ratio of 12, relative to the S&P 500 average P/E of 15.3. The financial statements reported net earnings of $126 million, or $4.00 per share. The notes to the financial statements included a statement that income for the year included a $31.5 million (after-tax) gain from the reclassification of certain assets from its investment portfolio to its trading portfolio. What would be the normalized P/E?

✗ **A) 15.**

✓ **B)** 16.

✗ **C)** 13.

Explanation

Since the P/E ratio was 12 and EPS was \$4, the price of the stock was \$48 (12 × 4). After removing the nonrecurring gain, earnings will be \$94.5 million (126 − 31.5). We know the number of shares is 31.5 million (126 Million ÷ 4). So the new EPS number is 3 (94.5 million ÷ 31.5 million) and new P/E ratio is 16 (48 ÷ 3).

Question #38 of 84

Question ID: 462496

Complete the following sentence. When earnings are relatively free of accruals, mean reversion will occur ___________.

✗ **A) at the same rate as usual.**

✗ **B)** relatively faster than usual.

✓ **C)** relatively slower than usual.

Explanation

Earnings consist of cash flow and accruals and there is an inverse relationship between accruals and cash flow. When earnings are relatively free of accruals, mean reversion will occur at a slower rate. The opposite is true when earnings are largely comprised of accruals.

Question #39 of 84

Question ID: 472503

Pysha Heavy Metals Ltd. supplies specialized metals to the chip fabrication industry. Selected financial data for Pysha, as well as industry comparables, are shown below:

Pysha selected financial data (£ '000s):

	20x7	*20x8*	*20x9*
Sales	1,169	1,312	1,414
Accounts receivable	58.45	72.16	98.98

Industry average:

	20x7	*20x8*	*20x9*
DSO	22.6	22.8	22.4
Receivables turnover	16.2	16.0	16.3

Based on the trend in revenues and receivables, it can be *most accurately* concluded that:

✗ **A) Pysha's revenues are growing at a faster rate than its receivables.**

✓ **B)** Pysha's revenues are growing at a slower rate than its receivables

✗ **C)** The revenue growth rate divided by receivables growth rate is increasing over time.

Explanation

Pysha's revenue growth rate is lagging the receivables growth rate.

	20x7	*20x8*	*20x9*
Revenue growth	-	12.23%	7.77%
Receivable growth	-	23.46%	37.17%
Ratio		52.15%	20.92%

Question #40 of 84

Question ID: 462527

Assume that inventory costs are increasing in line with an overall inflation rate of 3 percent. If a firm reports inventory using the last in, first out (LIFO) method, which of the following is *most* accurate?

✓ **A) Lower profits and lower taxes are reported because new inventory is flowing out to COGS.**

✗ **B)** The less expensive inventory is flowing out to COGS.

✗ **C)** LIFO reserve measures the accumulation of taxes paid.

Explanation

LIFO firm reports lower profits and lower taxes because all of the new, mores expensive inventory is flowing out to COGS thus, LIFO reserve measures the accumulation of taxes *not* paid and profits *not* recognized.

Question #41 of 84

Question ID: 462529

Coastal Drilling Corp (CDC) reported the following year-end data:

EBIT	$23 million
EBT	$20 million
Effective tax rate	40 percent

CDC reported in the footnotes to its financial statements that it had increased the expected return on pension plan assets assumption which resulted in an increase of EBIT of $2 million. Analyst Wanda Brunner, CFA, thinks this change in assumptions is unfounded and removes the $2 million increase in EBIT. Which of the following is *closest to* the tax burden ratio after adjustment?

✗ **A) 55.6%.**

✗ **B)** 61.9%.

✓ **C)** 60.0%.

Explanation

Tax burden = NI/EBT or 1 - the effective tax rate. The increase in the return on pension plan assets assumption increased EBIT, EBT, Income Taxes, and Net Income from what it would have been. Removing $2 million from the reported numbers will reduce EBIT, EBT, Income Taxes, and Net Income. However, the tax burden ratio will still be 1 - the effective tax rate.

Question #42 of 84

Question ID: 462518

Lucky Strike Mining Corp. (LSMC) reports in a footnote to the financial statements that it is party to a variable interest entity (VIE) through which it leases heavy equipment. LSMC has chosen not to report a residual value guarantee of $120 million for the equipment because it is not required to do so under accounting standards. However, the standards will change next year. What is the appropriate analytical treatment of this residual value guarantee?

✗ **A)** **Ignore the liability because current accounting standards do not require it to be included on the balance sheet. Include it in next year's balance sheet adjustments.**

✗ **B)** Increase long-term liabilities by $120 million and decrease equity by $120 million.

✓ **C)** Increase long-term liabilities and long-term assets by $120 million.

Explanation

Increase long-term liabilities and long-term assets by $120 million.

Question #43 of 84

Question ID: 414673

Charger Corporation offers extended payment terms to its customers. In order to finance its accounts receivable, Charger is considering two alternatives. The first alternative is to borrow against the receivables. The second alternative is to securitize the receivables through a special purpose entity. Which alternative would result in lower operating cash flow and lower financing cash flow?

	Lower operating cash flow	Lower financing cash flow
✗ **A)**	**Securitize**	**Securitize**
✗ **B)**	Securitize	Borrow
✓ **C)**	Borrow	Securitize

Explanation

The cash received from borrowing would be reported as a financing inflow. The cash received from securitizing the receivables would be reported as an operating inflow. So, borrowing would result in lower operating cash flow and higher financing cash flow. Securitizing would result in lower financing cash flow and higher operating cash flow.

Question #44 of 84

Question ID: 462502

Wanda Brunner, CFA, is analyzing Straight Elements, Inc., (SE). SE is a discount manufacturer of parts and supplies for the railroad industry. She has followed her firm's suggested financial analysis framework, and has assembled output from processing data. When applying the financial analysis framework, which of the following is the *best* example of output from processing data?

- ✗ **A) Audited financial statements.**
- ✓ **B)** Common-size financial statements.
- ✗ **C)** A written list of questions to be answered by the analysis.

Explanation

Common-size financial statements are created in the data processing step of the framework for financial analysis. Audited financial statements would be obtained during the "collect input" phase of the financial analysis framework. Creating a written list of questions to be answered by the analysis is part of the "define the purpose" phase of the financial analysis framework.

Question #45 of 84

Question ID: 462530

ABC Tie Company reports income for the year 2009 as $450,000. The notes to its financial statements state that the firm uses the last in, first out (LIFO) convention to value its inventories, and that had it used first in, first out (FIFO) instead, inventories would have been $62,000 greater for the year 2008 and $78,000 greater for the year 2009. If earnings were restated using FIFO to determine the cost of goods sold (COGS), what would the net income be for the year 2009? Assume a tax rate of 36%. Net income would have been:

- ✗ **A) $439,760.**
- ✗ **B)** $455,760.
- ✓ **C)** $460,240.

Explanation

The reduction in COGS would result in an *increase* in net income (62,000 − 78,000) × (1 − 0.36).

Question #46 of 84

Question ID: 462470

The failure to recognize inventory obsolescence is an example of ___________.

- ✗ **A) Misclassifying expenses.**
- ✓ **B)** Understating expenses.
- ✗ **C)** Delaying expenses.

Explanation

Inventory must be tested for obsolescence using the lower-of-cost-or-market method. Obsolete inventory must be written down (expensed) in the income statement which results in lower earnings. Thus, failure to recognize obsolescence understates expenses and overstates earnings.

Delaying expenses involves deferring recognition to a future period. Delaying expense is the result of capitalizing a cost instead of immediately recognizing the cost in the income statement. This is not the same as failing to recognize inventory obsolescence.

Investors typically focus more on operating income than nonrecurring and non-operating income. Thus, firms may have an incentive to increase operating income by misclassifying an operating expense as a nonrecurring or non-operating item. Therefore, failure to recognize obsolescence is not an example of misclassification.

Question #47 of 84

Question ID: 462501

An analyst is analyzing TRK Construction (TRK) for possible recommendation to his firm's clients. He wants to use TRK's financial statements to answer such questions as "Is TRK suitable for firm clients?", "Is TRK priced properly relative to peers?", "What is TRK's earnings quality?" The analyst is *most likely* to begin with:

- ✗ **A)** **a DuPont analysis.**
- ✓ **B)** a review of his firm's framework for analysis of financial statements.
- ✗ **C)** analysts adjustments to the financial statements.

Explanation

Analysis of financial statements should be performed in the context of an overall framework for the analysis of financial statements. Specific adjustments or analysis of specific ratios is a secondary concern.

Question #48 of 84

Question ID: 462532

Which of the following statements is CORRECT when inventory prices are falling?

- ✗ **A)** **LIFO results in higher COGS, lower earnings, higher taxes, and higher cash flows.**
- ✓ **B)** LIFO results in lower COGS, higher earnings, higher taxes, and lower cash flows.
- ✗ **C)** LIFO results in lower COGS, lower earnings, lower taxes, and higher cash flows.

Explanation

Remember, *prices are falling*. Under LIFO, the most recent purchases flow to COGS. So, LIFO results in lower COGS, higher earnings, higher taxes, and lower cash flows.

Question #49 of 84

Question ID: 472507

Samuel Maskin, CFA is evaluating the financial statements of Northern Energy Inc. The following is an extract from Northern's cash flow statement for the past three years:

	20x6	**20x5**	**20x4**
Net Income	$1,023	$988	$744
Depreciation	$187	$145	$128
Restructuring Charges	$(108)	$(104)	$212
Accounts receivable	$(172)	$(145)	$(33)
Inventories	$(418)	$(202)	**$(180)**
Accounts Payable	$38	$37	$33
OCF	$550	$719	$904

Which of the following conclusions is least likely for Northern?

✗ **A) Days sales outstanding is probably increasing.**

✓ **B)** Northern is stretching payables.

✗ **C)** Northern may have accelerated revenue recognition.

Explanation

We are not provided with income statement data such as revenues and COGS and hence have to make inferences from the information provided. Accounts payable seem to be stable and decreasing as a percentage of net income making the conclusion of stretching payables least likely. Revenue acceleration can be concluded based on large increase in inventory in 20x6 (possibly reflecting returns from customers) combined with increases in accounts receivable over time. Increases in accounts receivable (relative to earnings) also would indicate that days sales outstanding would most likely be increasing.

Question #50 of 84

Question ID: 462534

A firm has reported net income of $136 million, but the notes to financial statements includes a statement that the results "include a $27 million charge for non-insured earthquake damage" and a "gain on the sale of certain assets during restructuring of $16 million." If we assume that both of these items are given on a pre-tax basis and the effective tax rate is 36%, what would be the "normal income"?

✗ **A) $147.00 million.**

✓ **B)** $143.04 million.

✗ **C)** $94.08 million.

Explanation

To normalize earnings you would increase it by the non-recurring charge of $27 million and decrease it by the non-recurring gain, both tax adjusted.

$136 + (27 - 16)(1 - 0.36) = $143.04.

Question #51 of 84

Question ID: 462519

Adjustments for off-balance-sheet items include all but which of the following?

✓ **A) Using the equity method in place of the proportionate consolidation to reflect the investment in affiliates.**

✗ **B)** Capitalizing operating leases, including this amount as an asset and a liability.

✗ **C)** Estimating the probable obligation for contingent liabilities.

Explanation

The correct statement is that proportionate consolidation should be used in place of the equity method.

Question #52 of 84

Question ID: 462483

In measuring earnings quality, which of the following statements is *most* appropriate?

✗ **A)** **Accruals can be measured as net income less cash flows from operations (CFO) less cash flows from financing (CFF).**

✗ **B)** The higher the accruals ratio, the higher the earnings quality.

✓ **C)** Accruals can be measured as the change in net operating assets (NOA) over a period of time.

Explanation

Using the balance sheet, we can measure accruals as the change in net operating assets (NOA) over a period of time. NOA is the difference in operating assets and operating liabilities. Operating assets are equal to total assets minus cash, equivalents to cash, and marketable securities. Operating liabilities are equal to total liabilities minus total debt (both short-term and long-term). In summary, the formula for balance sheet based aggregate accruals is:

> $\text{Accruals}^{BS} = \text{NOA}_{END} - \text{NOA}_{BEG}$

We can also derive the aggregate accruals by subtracting cash flow from operating activities (CFO) and cash flow from investing activities (CFI) from reported earnings as follows:

> $\text{Accruals}^{CF} = \text{NI} - \text{CFO} - \text{CFI}$

The *lower* the accruals ratio, the higher the earnings quality.

Question #53 of 84

Question ID: 472491

Which of the following choices is *most likely* a biased accounting choice to overstate profitability?

✓ **A)** **Lessor use of finance lease classification.**

✗ **B)** Classifying non-operating expenses as operating.

✗ **C)** Channeling gains through OCI and losses through income statement.

Explanation

Lessor use of finance lease classification results in Lessor recognizing the gross profit at inception of the lease and is a mechanism to overstate profitability. Classifying non-operating expenses as operating and channeling gains through OCI and losses through income statement would understate profitability.

Question #54 of 84

Question ID: 414669

Frank Brill, CFA, is concerned that Moses Aviation is overstating its profits. The *best* indicator of such action would be Moses Aviation's:

✓ **A)** **recognition of revenue from barter transactions.**

✗ **B)** sales-growth rate of nearly twice the industry average.

✗ **C)** rising inventory.

Explanation

While an unusually high sales-growth rate may indicate fraud, it could also indicate good management. It's a yellow flag, but not the best indicator of accounting shenanigans. Rising inventory is also a dual signal. It could be meant to overstate profits, or it could simply reflect an actual buildup of inventory in response to market forces or corporate operations. However, companies should not recognize revenue from barter transactions. The additional revenue is likely to improperly boost profits.

Question #55 of 84

Question ID: 462493

Complete the following sentence. An analyst would apply __________ to the cash component of income compared to the accrual component when evaluating company performance.

✗ **A)** **the same weighting.**

✓ **B)** a higher weighting.

✗ **C)** a lower weighting.

Explanation

Since the cash component has more sustainability in the future than the accrual component, an analyst would apply a higher weighting to the cash component of income than the accrual component when evaluating company performance.

Question #56 of 84

Question ID: 472501

Mean reversion in earnings means that:

✗ **A)** **Extreme high earnings will revert to the mean but extreme low earnings will not.**

✗ **B)** Extreme low earnings will revert to the mean but extreme high earnings will not.

✓ **C)** Extreme high as well as low levels of earnings will revert to the mean.

Explanation

Mean reversion in earnings means that extreme high or low earnings are not sustainable and will mean revert.

Question #57 of 84

Question ID: 485740

Classification of non-operating income as operating would lead to stated earnings that are likely to be:

✗ **A)** **non-compliant with GAAP.**

✓ **B)** compliant with GAAP but not sustainable.

✗ **C)** compliant with GAAP and sustainable.

Explanation

Non-operating income is less likely to recur and hence the earnings that include such misclassified non-operating income would be considered non-sustainable. The misclassification need not always be GAAP non-compliant.

Question #58 of 84

Question ID: 472499

Which one of the following choices is *least likely* to be an indicator of poor-quality earnings?

✓ **A) Reported earnings handily beat analyst estimates.**

✗ **B)** An investigation by the market regulatory authority is initiated.

✗ **C)** Restatement of previously issued financial statements.

Explanation

Enforcement actions by regulatory authorities and restatements of previously issued financial statements are two (external) indicators of poor-quality earnings. Earnings that meet or narrowly beat analyst estimates are considered to be suspect for poor quality. Handily beating analyst estimates is not considered to be an indicator of poor-quality earnings.

Question #59 of 84

Question ID: 462516

Northern Bottling (NB) currently shows minimum expected operating lease payments over the next 5 years of $3 million, $2.5 million, $2 million, $2 million, and $1.5 million. The firm's footnotes show a present value of future capital lease payments of $10.55m discounted at a rate of 6.75%. What adjustments would an analyst make to modify the balance sheet of NB to include this off-balance sheet financing? Increase long-term:

✓ **A) assets and long-term liabilities by $9.27 million.**

✗ **B)** liabilities by $9.27 million and decrease equity by $9.27 million.

✗ **C)** assets and long-term liabilities by $9.22 million.

Explanation

The operating lease should be capitalized at the rate used to calculate the PV of futurecapital lease payments in the footnotes. Therefore, the PV (operating leases) is:

> $= 3 / (1 + 0.0675) + 2.5 / (1 + 0.0675)^2 + 2 / (1+ 0.0675)^3 + 2 / (1 + 0.0675)^4 + 1.5 / (1 + 0.0675)^5$
> $= 9.27$ million

The proper adjustment is to increase both long-term assets and liabilities by the same amount.

Question #60 of 84

Question ID: 472511

Asma Pharma has made several strategic investments in other pharmaceutical companies. In each instance, Asma has kept its stake just below 50% so it can account for the investment using the equity method of consolidation.

Asma's balance sheet quality can be *most accurately* characterized as:

✓ **A) Low-quality due to lack of completeness.**

✗ **B)** Low-quality due to bias in measurement.

✗ **C)** High-quality due to compliance with local GAAP.

Explanation

One-line consolidation under the equity method obscures the components of balance sheet and artificially boosts certain profitability ratios (e.g., return on assets or profit margin). This reduces the completeness and quality of the firm's balance sheet. Compliance with GAAP is a necessary but not sufficient condition for evaluating quality of financial statements. Equity method of accounting does not by itself lead to measurement bias.

Question #61 of 84

Question ID: 472505

High-quality cash flow is *least likely* to be characterized by:

✗ **A)** **Volatility of operating cash flow being lower than that of the firm's peers.**

✗ **B)** No significant differences between operating cash flow and reported earnings.

✓ **C)** Financing cash flows sufficient to cover capital expenditures, dividends and debt repayments.

Explanation

High-quality cash flow is characterized by positive OCF that is derived from sustainable sources and is adequate to cover capital expenditures, dividends, and debt repayments. Furthermore, high-quality OCF is characterized by lower volatility than that of the firm's peers. Significant differences between OCF and earnings, or differences that widen over time, can be an indicator of earnings manipulation.

Question #62 of 84

Question ID: 472496

Brent Jones, CFA is analyzing the financial statements of Imperial Resorts Inc. Jones wants to use the Beneish model to evaluate the probability of earnings manipulation.

Jones makes the following statements:

1. Depreciation index of less than 1 would indicate that the company is depreciating assets at a higher rate than its peers.
2. Increases in Asset quality index indicate that the revenue recognition policies are conservative.

Regarding the statements by Jones:

✗ **A)** **Only statement 1 is correct.**

✓ **B)** None of the statements is correct.

✗ **C)** Only statement 2 is correct.

Explanation

Statement 1 is incorrect. Depreciation index less than 1 indicates that the company is depreciating assets at a higher rate than in prior years (and not relative to its peers). Statement 2 is incorrect. Asset quality index is used as an indicator of excessive capitalization of expenses.

Question #63 of 84

Question ID: 462515

Which of the following statements regarding adjustments an analyst may make before analyzing a set of financial statements is *least* accurate?

✗ **A)** **Income statement items that may require adjustment include accounting changes, one-time charges and restructuring charges.**

✓ **B)** The income statement should be adjusted to reflect the liability for purchases committed to under a take-or-pay contract.

✗ **C)** Cash flow from operations may be affected by the exclusion of off-balance sheet obligations.

Explanation

The liability for goods under take or pay contracts would be shown on the balance sheet (not income statement). Off-balance sheet obligations such as operating lease would affect Cash flow from operations (as opposed to treatment under capital lease).

Question #64 of 84

Question ID: 472504

Pysha Heavy Metals Ltd. supplies specialized metals to the chip fabrication industry. Selected financial data for Pysha, as well as industry comparables, are shown below:

Pysha selected financial data (£ '000s):

	20x7	*20x8*	*20x9*
Sales	1,169	1,312	1,414
Accounts receivable	58.45	72.16	98.98

Industry average:

	20x7	*20x8*	*20x9*
DSO	22.6	22.8	22.4
Receivables turnover	16.2	16.0	16.3

Relative to industry average, for 20x9, Pysha's DSO and Receivables turnover are *most likely*:

	DSO	Receivables turnover
✗ **A)**	**Higher**	**higher**
✗ **B)**	Lower	higher
✓ **C)**	Higher	lower

Explanation

Pysha's DSO and receivables turnover is calculated as follows:

DSO	18.25	20.08	25.55
receviables turnover	20.00	18.18	14.29

For 20x9, industry DSO and receivables turnover are given as 22.4 and 16.3 respectively. Hence Pysha's DSO is higher and receivable turnover is lower than industry average.

Question #65 of 84

Question ID: 485739

In the context of the Beneish model to evaluate the probability of earnings manipulation, an increase in Days Sales Receivable Index is *least likely* to signify:

✗ **A)** **an increase in M-score.**

✓ **B)** a decrease in probability of earnings manipulation.

✗ **C)** revenue inflation.

Explanation

An increase in Days Sales Receivable Index indicates revenue inflation and increases the M-score, thereby increasing the probability of earnings manipulation.

Question #66 of 84

Question ID: 472495

Pritesh Deshmukh, CFA is analyzing the financial statements of Baza Restaurants Inc. Deshmukh wants to use the Beneish model to evaluate the probability of earnings manipulation.

Deshmukh makes the following statements:

1. Depreciation index of less than 1 would indicate that the company is depreciating assets at a lower rate than in prior years.
2. Sales growth index of more than 1 indicates revenue inflation.

Which of the statements by Deshmukh are most accurate?

✗ **A)** **Statement 1 only.**

✓ **B)** None of the statements is accurate.

✗ **C)** Statement 2 only.

Explanation

Statement 1 is incorrect. Depreciation index of less than 1 indicates that the company is depreciating assets at a higher rate than in prior years. Statement 2 is incorrect. Sales growth index of more than 1 simply implies that the growth in sales is positive. While not a measure of manipulation by itself, growth companies tend to find themselves under pressure to manipulate earnings to meet ongoing expectations.

Question #67 of 84

Question ID: 462523

A manufacturing firm purchases equipment for use in its operations. With regard to recording the purchase using the cash basis versus the accrual basis of accounting, which of the following statements is *most* appropriate?

✗ **A)** **With the accrual basis, the cost of the equipment is allocated to the cash flow statements over the asset's life.**

✓ **B)** With the cash basis, revenues and expenses relating to the equipment are generally recognized in different periods.

✗ **C)** With the cash basis, revenues and expenses relating to the equipment are generally recognized in the same period.

Explanation

With the *cash basis* of accounting, revenues are recognized when cash is collected and expenses are recognized when cash is paid. Therefore, the cash flows may occur in different periods than when the revenues are actually earned or when the expenses are actually incurred. For example, the purchase of equipment used in a firm's manufacturing operation may result in an immediate cash outflow but the equipment generates revenues over its useful life. In this case, the revenues and expense are reported in different periods.

With the *accrual basis* of accounting, revenues are recognized when earned and expenses are recognized when incurred, regardless of the timing of the cash flows. With the equipment purchase, the cost of the equipment will be allocated to the income statement (not cash flow statement) over the asset's life and at the same time, matched with the revenues generated.

Question #68 of 84

Question ID: 462469

Which of the following items is *least likely* to involve the use of subjective measurement estimates by management?

- ✓ **A)** **Use of criteria to determine treatment as an extraordinary item.**
- ✗ **B)** Use of straight-line depreciation method to depreciate tangible assets.
- ✗ **C)** Use of FIFO (first in-first out) to cost inventories.

Explanation

The use of criteria to determine treatment as an extraordinary item (i.e. Is the item within management's discretion? Is the event likely to recur in the foreseeable future?) does not involve numerical and subjective estimates per se. It is more a test of qualitative factors to determine the proper classification. Contrast this to FIFO, which is clearly a numerical estimate since an alternative of using LIFO (last in-first out) is possible and this will result in a different reported amount than FIFO. The same argument can be made for the use of the straight-line method since an alternative of using the declining-balance method is possible to depreciate tangible assets.

Question #69 of 84

Question ID: 472513

MKF Consolidated reports $500 million in goodwill on its balance sheet. The market consensus indicates that the value of MKF's intangible assets is $300 million. How should an analyst adjust MKF's balance sheet? Reduce goodwill and:

- ✗ **A)** **equity by $500 million while increasing liabilities by $300 million.**
- ✓ **B)** equity by $200 million.
- ✗ **C)** increase liabilities by $200 million.

Explanation

If goodwill has no economic value apart from the firm, it should be eliminated from the balance sheet. If the value of the intangibles can be reliably estimated they can be substituted for accounting goodwill.

Question #70 of 84

Question ID: 472509

Which of the following is *least likely* an indicator of biased measurement in assessing balance sheet quality?

✗ **A) Understatement of inventory impairment charges.**

✗ **B)** Understatement of valuation allowance for deferred tax assets.

✓ **C)** Presence of substantial goodwill on balance sheet.

Explanation

Presence of substantial goodwill does not inherently make it biased measurement. Only if the value of goodwill is unjustified (based on market values of the investments), would the measurement be considered biased. Understatement of inventory impairment charges overstates value of inventory. Similarly understatement of valuation allowance for deferred tax assets overstates the value of deferred tax assets.

Question #71 of 84

Question ID: 462497

Alex Fisher, CFA, is examining the phenomenon of mean reversion on the earnings of several firms. Which of the following statements regarding mean reversion is *least* accurate?

✗ **A) High earnings should not be expected to continue indefinitely.**

✓ **B)** Normal earnings should not be expected to continue indefinitely.

✗ **C)** Low earnings should not be expected to continue indefinitely.

Explanation

When examining net income, analysts should be aware that earnings at extreme levels tend to revert back to normal levels over time. This phenomenon is known as mean reversion. As a result of mean reversion, analysts must understand that extreme earnings (high or low) should not be expected to continue indefinitely.

Question #72 of 84

Question ID: 472502

Andre Bursh, is analyzing large retailers and has collected the following information on three companies based on the most recent financial statements:

	Allied Stores	Beta Mart	Cash-N-Carry
Total Earnings (per share)	$2.80	$1.33	$0.75
Cash element	$1.90	$0.78	$0.25
Accrual element	$0.90	$0.55	$0.50

Bursh notes that all three companies have reported stellar earnings this past year. Bursh is concerned about sustainability of such high earnings. Which company's earnings will revert to its mean fastest?

✗ **A) Beta Mart.**

✓ **B)** Cash-N-Carry.

✗ **C)** Allied Stores.

Explanation

Cash-N-Carry's earnings is comprised of large proportion of accruals (0.50/0.75 or 67%). Allied's accruals comprise

(0.90/1.90) 47% of earnings and Beta's accruals comprise 41% of earnings.

Question #73 of 84

Question ID: 462472

Marcel Schulte is analyzing various retailing firms. Which of the following items is *least* indicative of a potential problem with revenue recognition and earnings quality?

✗ **A)** **Use of barter transactions.**

✓ **B)** Disproportionate revenues in the last quarter of the calendar year.

✗ **C)** Implementing a "bill and hold" arrangement.

Explanation

Disproportionate revenues in the last quarter may be an indication of aggressive revenue recognition to meet analyst forecasts but it is much more likely if the firm is a *non-seasonal* one. A retailing firm presumably has a disproportionate amount of sales during the busy Christmas season in the last quarter of the calendar year so this point alone would not be indicative of a potential problem.

In a barter transaction, two parties exchange goods or services. The main issue is whether: (a) a sale transaction has actually occurred in substance; (b) it is not a "sham" transaction; and (c) the transaction amount is overstated.

Bill and hold occurs when the retailer (seller) invoices the customer but does not ship the goods until a later date. Alternatively, the seller may ship the goods to a location other than the customer's. In either case, the seller may be recognizing revenue prematurely.

Question #74 of 84

Question ID: 472498

Classification shifting is *least likely* to result in a higher:

✗ **A)** **firm value derived when cash flow forecasts are based on core earnings.**

✗ **B)** equity value derived when earnings forecasts are based on operating earnings.

✓ **C)** reported net income.

Explanation

Classification shifting results in inflation of core or recurring earnings while keeping the total reported income same. This is used to mislead analysts into using a higher number as a basis for generating forecasts of future earnings and cash flows. Such erroneous forecasts would then result in inflated equity and firm valuation.

Question #75 of 84

Question ID: 434317

Charles Nicholls, chief investment officer of Gertmann Money Management, is reviewing the year-end financial statements of Zartner Canneries. In those statements he sees a sharp increase in inventories well above the sales-growth rate, and an increase in the discount rate for its pension liabilities. To determine whether or not Zartner Canneries is cooking the books, what should Nicholls do?

✗ **A)** **Check Zartner's cash-flow statement and review its footnotes.**

✗ **B)** Analyze trends in Zartner's receivables and consider the changing characteristics of its work force.

✓ **C)** Calculate Zartner's turnover ratios and review the footnotes of its competitors.

Explanation

To assess the meaning of the inventory increase, look for declines in industry turnover. And if Zartner changes its pension assumptions, Nicholls should see how those new assumptions compare to those found in the footnotes of financial statements from other companies in the same industry.

Question #76 of 84

Question ID: 462504

An analyst is developing a framework for financial statement analysis for his firm. This framework is *most likely* to include:

✗ **A) Determine the allocation of firm fees, interpret processed data, and communicate conclusions.**

✗ **B)** Maintain integrity of capital markets, perform duties to clients and employers, and avoid conflicts of interest.

✓ **C)** Define the purpose of the analysis, process input data, and follow up.

Explanation

Proper analysis framework should include:

1. Define the purpose of the analysis.
2. Collect input data.
3. Process input data.
4. Interpret processed data.
5. Develop and communicate conclusions.
6. Follow up.

Question #77 of 84

Question ID: 462520

What does the LIFO reserve measure?

✓ **A) The accumulated difference between the reported inventory balance and the cost of that inventory if first in, first out (FIFO) had been used.**

✗ **B)** The overstatement relative to the current cost of inventory.

✗ **C)** The results of older inventory flowing to cost of goods sold (COGS).

Explanation

The LIFO reserve measures the accumulated difference between the reported inventory balance and the cost of that inventory if FIFO had been used.

Question #78 of 84

Question ID: 462505

An analyst is analyzing a discount manufacturer of parts and supplies. She has followed her firm's suggested financial analysis framework and has communicated with company suppliers, customers, and competitors. This is an input that occurs while:

- ✗ **A) processing data.**
- ✓ **B)** collecting data.
- ✗ **C)** establishing the objective of the analysis.

Explanation

Communication with management, suppliers, customers, and competitors is an input during the data collection step. Processing data is the third phase of the financial analysis framework. Establishing the objective of the analysis is part of the "define the purpose" phase of the financial analysis framework.

Question #79 of 84

Question ID: 472493

Errors that affect multiple financial statement elements are most likely to arise from:

- ✗ **A) compound issues.**
- ✗ **B)** classification issues.
- ✓ **C)** measurement and timing issues.

Explanation

Measurement and timing issues typically affect multiple financial statement elements while classification issues typically affects categorization of a specific element in a financial statement.

Question #80 of 84

Question ID: 462499

Which of the following measures is *least* affected by the use of estimates in the financial statement preparation process?

- ✗ **A) Net income.**
- ✓ **B)** Cash flow.
- ✗ **C)** Net equity.

Explanation

Net income is easily manipulated because of accrual accounting and the many estimates involved. On the other hand, cash flow is unaffected by estimates. However, firms can still manipulate the cash flow statement by misclassifying cash flows, ignoring cash flows, and managing cash flows.

As a result of its relationship to the income statement, net equity (which is generally an accumulation of earnings and losses less dividend payments to shareholders) is directly affected by the estimates used to determine the level of earnings.

Question #81 of 84

Question ID: 472489

High results quality is *most likely* demonstrated by:

✗ **A)** **GAAP compliant financial reports that are decision useful.**

✓ **B)** an adequate level of return that is sustainable.

✗ **C)** high level of earnings determined conservatively.

Explanation

High results quality occurs if the level of earnings provides an adequate level of return and that the earnings are sustainable.

Question #82 of 84

Question ID: 472500

Sustainable earnings are most likely to be driven by:

✗ **A)** **Accruals element of earnings.**

✗ **B)** Conservative revenue recognition practices.

✓ **C)** Cash flow element of earnings.

Explanation

Sustainable and persistent earnings are driven by cash flow element of earnings. The stability and accuracy of earnings forecasts can be reduced by estimation process that generates the accruals component of earnings. Conservative and aggressive revenue recognition practices both would result in reversion in earnings (and hence lowers the sustainability of earnings).

Question #83 of 84

Question ID: 472512

The *least* valuable source of information about a businesses' risk is:

✗ **A)** **Notes to financial statements.**

✗ **B)** Management discussion and analysis section of the annual report.

✓ **C)** Auditor's report.

Explanation

Because an audit report provides only historical information, such a report's usefulness as an information source is limited. Companies are required to make certain risk related disclosures in the notes to financial statements. Both GAAP and IFRS require companies to disclose risks related to pension benefits, contingent obligations and financial instruments. Ideally, companies should include principal risks that are unique to the business (as opposed to risks faced by most businesses) in their MD&A.

Question #84 of 84

Question ID: 472510

Which of the following is *least likely* an indicator of biased measurement in assessing balance sheet quality?

✗ **A)** **Understatement of impairment charges for property, plan and equipment.**

✓ **B)** Company's investment in debt securities of other companies, carried on the books at market value.

✗ **C)** Overly high assumed discount rate for pension obligations.

Explanation

Carrying investments in debt (or equity) securities at market value enhances balance sheet quality and does not introduce a bias in the estimate. Understatement of impairment charges on PP&E overstates value of PP&E. High discount rate reduces the value of PBO and hence improves the funded position reflected on the balance sheet.