SS 09 Financial Reporting and Analysis: Financial Reporting Quality and Financial Statement Analysis
Answers

Question #1 of 51

Question ID: 500867

An analyst has decided to identify value stocks for investment by screening for companies with high book-to-market ratios and high dividend yields. A potential drawback of using these screens to find value stocks is that the firms selected may:

- ✓ **A)** be concentrated in specific industries.
- ✗ **B)** be those that have significantly underperformed the market.
- ✗ **C)** have unsustainable dividend payments.

Explanation

A screen for firms with high dividend yields and high book-to-market ratios would likely result in an inordinate proportion of financial services companies and add a significant element of industry (sector) risk. Uncertainty about sustainability of dividend payments and recent market underperformance are typical characteristics of value stocks in general and not a drawback to using this screen to identify them.

References

Question From: Session 9 > Reading 33 > LOS d

Related Material:

- Key Concepts by LOS

Question #2 of 51

Question ID: 456304

A significant increase in days payables above historical levels is *most likely* associated with:

- ✗ **A)** an increase in net working capital.
- ✗ **B)** an unsustainable increase in reported earnings.
- ✓ **C)** low quality of the cash flow statement.

Explanation

A significant increase in days payables may indicate that payables have been "stretched" (not paid or paid more slowly), which increases operating cash flow in an unsustainable manner and calls the quality of the reported cash flow values into question. Stretching payables does not affect earnings because the related expenses were recognized in the period incurred. An increase in days payables will decrease net working capital, other things equal.

References

Question From: Session 9 > Reading 32 > LOS i

Related Material:

- Key Concepts by LOS

Question #3 of 51

Question ID: 414688

An analyst screening potential equity investments to identify value stocks is *most likely* to exclude companies with:

- ✗ **A)** high dividend payout ratios.
- ✗ **B)** low earnings growth rates.
- ✓ **C)** high price-to-earnings ratios.

Explanation

Value stocks are considered to be those that have low prices relative to earnings (or relative to sales, cash flow, or book value). Screens that exclude firms with low earnings growth rates or high dividend payout ratios are more likely to be used to identify growth stocks.

References

Question From: Session 9 > Reading 33 > LOS d

Related Material:

- Key Concepts by LOS

Question #4 of 51

Question ID: 460655

Which of the following actions is *least likely* to increase earnings for the current period?

- ✓ **A)** Decreasing the salvage value of depreciable assets.
- ✗ **B)** Selling more inventory than is purchased or produced.
- ✗ **C)** Recognizing revenue before fulfilling the terms of a sale.

Explanation

Decreasing the salvage value will result in higher depreciation expense and lower earnings in the current period. Recognizing revenue before fulfilling all terms of a sale is an aggressive revenue recognition method that will increase earnings in the current period. For firms that use LIFO inventory accounting and in an increasing price environment, selling more inventory than is purchased or produced will increase earnings unsustainably in the current period.

References

Question From: Session 9 > Reading 32 > LOS h

Related Material:

- Key Concepts by LOS

Question #5 of 51

Question ID: 460656

Under which inventory cost flow assumption is a firm *most likely* to show an unusual increase in gross profit margin by sales in excess of current period production?

- ✓ **A)** LIFO.
- ✗ **B)** Average cost.
- ✗ **C)** FIFO.

Explanation

Under LIFO and with increasing prices, a firm that sells more goods than it purchases or produces in a period may show an unsustainable increase in gross profit margin because items recognized in cost of sales are valued older, lower prices, while sales are recorded at current, higher prices.

References

Question From: Session 9 > Reading 32 > LOS i

Related Material:

- Key Concepts by LOS

Question #6 of 51

Question ID: 414689

Comet Corporation is a capital intensive, growing firm. Comet operates in an inflationary environment and its inventory quantities are stable. Which of the following accounting methods will cause Comet to report a lower price-to-book ratio, all else equal?

	Inventory method	Depreciation method
✗ **A)**	Last-in, First-out	Accelerated
✓ **B)**	First-in, First-out	Straight-line
✗ **C)**	First-in, First-out	Accelerated

Explanation

FIFO results in higher assets and higher equity in an inflationary environment as compared to LIFO. Equity is higher because COGS is lower (and inventory higher) under FIFO. Straight-line depreciation will result in greater assets and equity compared to accelerated depreciation for a stable or growing firm. Equity is greater because depreciation expense is less with straight-line depreciation. Greater equity will result in greater book value per common share, the denominator of the price-to-book ratio. Greater book value per share will result in a lower price-to-book ratio.

References

Question From: Session 9 > Reading 33 > LOS e

Related Material:

- Key Concepts by LOS

Question #7 of 51

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.

References

Question From: Session 9 > Reading 32 > LOS h

Related Material:

- Key Concepts by LOS

Question #8 of 51

Question ID: 434321

The price to tangible book value ratio subtracts what components from equity?

- ✓ **A)** Goodwill and intangible assets.
- ✗ **B)** Intangible assets and property, plant and equipment.
- ✗ **C)** Goodwill and property, plant and equipment.

Explanation

Price to tangible book value is calculated by removing goodwill and intangible assets from equity. This adjustment reduces assets and equity and produces a ratio that is not affected by differences in intangible asset values that may result from how the assets were acquired.

References

Question From: Session 9 > Reading 33 > LOS e

Related Material:

- Key Concepts by LOS

Question #9 of 51

Question ID: 500862

Which of the following is *least likely* one of the combinations of the quality of financial reporting and quality of reported earnings along the spectrum of financial report quality?

✓ **A)** Reporting is not compliant with GAAP, although reported earnings are sustainable and adequate.

✗ **B)** Reporting is compliant with GAAP, but the amount of earnings is actively managed to smooth earnings.

✗ **C)** Reporting is not compliant and includes numbers that are fictitious or fraudulent.

Explanation

When reporting is not compliant with GAAP, the sustainability and adequacy of reported earnings cannot be determined. The other two choices fall on the spectrum of the quality of financial reports.

References

Question From: Session 9 > Reading 32 > LOS b

Related Material:

- Key Concepts by LOS

Question #10 of 51

Question ID: 434319

Selected financial information gathered from Alpha Company and Omega Corporation follows:

	Alpha	Omega
Revenue	$1,650,000	$1,452,000
Earnings before interest, taxes, depreciation, and amortization	69,400	79,300
Quick assets	216,700	211,300
Average fixed assets	300,000	323,000
Current liabilities	361,000	404,400
Interest expense	44,000	58,100

Which of the following statements is *most* accurate?

✗ **A)** Alpha has a higher operating profit margin than Omega.

✓ **B)** Omega has lower interest coverage than Alpha.

✗ **C)** Omega uses its fixed assets more efficiently than Alpha.

Explanation

Using the EBITDA coverage ratio (EBITDA / Interest expense), Omega's EBITDA coverage is 1.4 ($79,300 EBITDA / $58,100 interest expense) and Alpha's EBITDA coverage is 1.6 ($69,400 EBITDA / $44,000 interest expense). Using EBITDA to measure operating profit, Alpha has a lower operating profit margin than Omega. Alpha's EBITDA margin is 4.2% ($69,400 EBITDA / $1,650,000 revenue) and Omega's EBITDA margin is 5.5% ($79,300 EBITDA / $1,452,000 revenue). Using fixed asset turnover to measure the efficiency of fixed assets, Omega uses its fixed assets less efficiently than Alpha. Alpha's fixed asset turnover is

5.5 ($1,650,000 revenue / $300,000 average fixed assets) and Omega's fixed asset turnover is 4.5 ($1,452,000 revenue / $323,000 average fixed assets).

References

Question From: Session 9 > Reading 33 > LOS c

Related Material:

- Key Concepts by LOS

Question #11 of 51

Question ID: 498765

An IFRS-reporting firm includes in its financial statements a measure that is not defined under IFRS. The firm is *least likely* required to:

- ✗ **A)** define and explain the relevance of this measure.
- ✓ **B)** show this measure for all periods presented.
- ✗ **C)** reconcile this measure with the most comparable IFRS measure.

Explanation

IFRS require firms that present a non-GAAP (i.e., non-IFRS) measure in their financial reports to define the measure and explain its relevance, and to reconcile the differences between this measure and the most comparable IFRS measure.

References

Question From: Session 9 > Reading 32 > LOS g

Related Material:

- Key Concepts by LOS

Question #12 of 51

Question ID: 492019

A spectrum for assessing financial reporting quality should consider:

- ✗ **A)** quality of financial reports only.
- ✗ **B)** quality of earnings only.
- ✓ **C)** both quality of financial reports and quality of earnings.

Explanation

Both quality of financial reports and quality of reported earnings are elements that should be considered in a spectrum for assessing financial reporting quality.

References

Question From: Session 9 > Reading 32 > LOS b

Related Material:

- Key Concepts by LOS

Question #13 of 51

Question ID: 500865

A mechanism to discipline financial reporting quality for securities that trade in the United States that is not typically imposed on security issuers elsewhere is that:

- ✗ **A)** the firm must provide a signed statement by the person responsible for preparing the financial statements.
- ✓ **B)** management must attest to the effectiveness of the firm's internal controls.
- ✗ **C)** financial statements must be audited by an independent party.

Explanation

A signed management statement about the effectiveness of the firm's internal controls is required by U.S. regulators for securities that trade in the U.S., but not elsewhere. The other two items are typically required by securities regulators worldwide.

References

Question From: Session 9 > Reading 32 > LOS f

Related Material:

- Key Concepts by LOS

Question #14 of 51

Question ID: 414683

Jane Epworth, CFA, is preparing pro forma financial statements for Gavin Industries, a mature U.S. manufacturing firm with three distinct geographic divisions in the Midwest, South and West. Epworth prepares estimates of sales for each of Gavin's divisions using economists' estimates of next-period GDP growth and sums the three estimates to forecast Gavin's sales. Epworth's approach to estimating Gavin's sales is:

- ✗ **A)** inappropriate, because sales should be forecast on a firm-wide basis.
- ✓ **B)** appropriate.
- ✗ **C)** inappropriate, because sales should be forecast on a firm-wide basis and are unlikely to be related to GDP growth.

Explanation

Sales estimates can be more sophisticated than simply estimating a single growth rate. One common approach is to estimate the linear relationship between sales growth and economic growth and use this relationship to estimate sales growth based on economists' forecasts of GDP growth. Segment-by-segment analysis can also be applied, summing segment or division sales forecasts to produce an overall sales forecast for the firm.

References

Question From: Session 9 > Reading 33 > LOS b

Related Material:

- Key Concepts by LOS

Question #15 of 51

Question ID: 414681

Baetica Company reported the following selected financial statement data for the year ended December 31, 20X7:

in millions		% of Sales
For the year ended December 31, 20X7:	$500	100%
Sales		
Cost of goods sold	(300)	60%
Selling and administration expenses	(125)	25%
Depreciation	(50)	10%
Net income	$25	5%
As of December 31, 20X7:		
Non-cash operating working capital [a]	$100	20%
Cash balance	$35	N/A

[a] Non-cash operating working capital = Receivables + Inventory - Payables

Baetica expects that sales will increase 20% in 20X8. In addition, Baetica expects to make fixed capital expenditures of $75 million in 20X8. Ignoring taxes, calculate Baetica's expected cash balance, as of December 31, 2008, assuming all of the common-size percentages remain constant.

- ✓ **A)** $30 million.
- ✗ **B)** $80 million.
- ✗ **C)** $40 million.

Explanation

2008 sales are expected to be $600 million ($500 million 2007 sales × 1.2) and 20X8 net income is expected to be $30 million ($600 million 20X8 sales × 5%). 2008 non-cash operating working capital is expected to be $120 million ($600 million 20X8 sales × 20%). The change in cash is expected to be -$5 million ($30 million 20X8 net income + $60 million 20X8 depreciation - $20 million increase in non-cash operating working capital - $75 million 20X8 capital expenditures). The 20X8 ending balance of cash is expected to be $30 million ($35 million beginning cash balance - $5 million decrease in cash).

References

Question From: Session 9 > Reading 33 > LOS b

Related Material:

- Key Concepts by LOS

Question #16 of 51

Question ID: 460654

Which of the following requirements are *most likely* to create incentives for management to manipulate earnings?

- ✗ **A)** Audit requirements.
- ✗ **B)** Disclosure regulations.
- ✓ **C)** Debt covenants.

Explanation

Debt covenants that require a firm to meet minimum financial measures may give management an incentive to manipulate earnings. Audit requirements and disclosure regulations are mechanisms that discipline financial reporting quality.

References

Question From: Session 9 > Reading 32 > LOS d

Related Material:

- Key Concepts by LOS

Question #17 of 51

Question ID: 414692

Patch Grove Nursery uses the LIFO inventory accounting method. Maria Huff, president, wants to determine the financial statement impact of changing to the FIFO accounting method. Selected company information follows:

- Year-end inventory: $22,000
- LIFO reserve: $4,000
- Change in LIFO reserve: $1,000
- LIFO cost of goods sold: $18,000
- After-tax income: $2,000
- Tax rate: 40%

Under FIFO, the nursery's ending inventory and after-tax profit for the year would have been:

	FIFO ending inventory	FIFO after-tax profit
✓ **A)**	$26,000	$2,600
✗ **B)**	$18,000	$2,600
✗ **C)**	$26,000	$1,400

Explanation

FIFO ending inventory = LIFO ending inventory + LIFO reserve = 22,000 + 4,000 = $26,000

FIFO after-tax profit = LIFO after-tax profit + (change in LIFO reserve)(1 − t) = \$2,000 + (\$1,000)(1 − 0.4) = \$2,000 + \$600 = \$2,600

References

Question From: Session 9 > Reading 33 > LOS e

Related Material:

- Key Concepts by LOS

Question #18 of 51

Question ID: 500868

A firm has a debt-to-equity ratio of 0.50 and debt equal to \$35 million. The firm acquires new equipment with a 3-year operating lease that has a present value of lease payments of \$12 million. The most appropriate analyst treatment of this operating lease will:

✓ **A)** increase the debt-to-equity ratio to 0.67.

✗ **B)** leave the debt-to-equity ratio unchanged at 0.5.

✗ **C)** increase the debt-to-equity ratio to 0.57.

Explanation

Shareholders' equity = \$35 million / 0.5 = \$70 million. The most appropriate analyst adjustment for an operating lease is to add the present value of lease payments to the firm's assets and long-term debt (leaving equity unchanged). This will result in a debt-to-equity ratio of (\$35 million + \$12 million) / \$70 million = 0.6714.

References

Question From: Session 9 > Reading 33 > LOS e

Related Material:

- Key Concepts by LOS

Question #19 of 51

Question ID: 414653

If management is manipulating financial reporting to avoid breaching an interest coverage ratio covenant on the firm's debt, they are *most likely* to:

✓ **A)** overstate earnings.

✗ **B)** understate assets.

✗ **C)** capitalize leases.

Explanation

Debt covenants may require a firm to maintain a minimum interest coverage ratio (EBIT / interest expense). Manipulating the financial statements to increase the interest coverage ratio would most likely involve overstating earnings, or possibly understating liabilities (for example by using operating leases instead of capital leases) to decrease interest expense. Understating or overstating assets would not affect the interest coverage ratio.

References

Question From: Session 9 > Reading 32 > LOS h

Related Material:

- Key Concepts by LOS

Question #20 of 51

Question ID: 492018

On a spectrum for assessing financial reporting quality, which of the following represents the highest quality?

- ✓ **A)** Reporting is compliant with GAAP and decision useful but earnings are not sustainable.
- ✗ **B)** Reporting is not compliant with GAAP but the numbers presented reflect the company's actual activities.
- ✗ **C)** Reporting is compliant with GAAP but reporting choices and estimates are biased.

Explanation

A firm can have high financial reporting quality even if its earnings quality is low, such as a firm that recognizes one-time gains in a period and identifies them clearly. Biased accounting choices and non-compliance with GAAP represent lower-quality financial reporting.

References

Question From: Session 9 > Reading 32 > LOS b

Related Material:

- Key Concepts by LOS

Question #21 of 51

Question ID: 500861

The quality of a company's reported earnings is low when they:

- ✓ **A)** are not sustainable.
- ✗ **B)** do not conform to GAAP.
- ✗ **C)** are lower than for the prior-year period.

Explanation

The quality of a firm's earnings is considered to be low if they are not sustainable or if they are not of a sufficient level to provide an adequate return to investors. When financial reports do not conform with GAAP, the user cannot evaluate the quality of earnings in terms of adequacy or sustainability.

References

Question From: Session 9 > Reading 32 > LOS a

Related Material:

- Key Concepts by LOS

Question #22 of 51

Question ID: 492020

In which of the following situations is management *most likely* to make conservative choices and estimates that reduce the quality of financial reports?

- ✗ **A)** The firm must meet accounting benchmarks to comply with debt covenants.
- ✓ **B)** Earnings for a period will be higher than analysts' expectations.
- ✗ **C)** Management's compensation is closely tied to near-term performance of the firm's stock.

Explanation

Management might be motivated to "manage earnings" by making conservative choices and estimates in periods when earnings are higher than expected, delaying recognition of some of these earnings to later periods. Meeting debt covenants or improving stock performance in the near term are more likely to motivate management to make aggressive accounting choices and estimates.

References

Question From: Session 9 > Reading 32 > LOS d

Related Material:

- Key Concepts by LOS

Question #23 of 51

Question ID: 414691

At the end of 2007, Decatur Corporation reported last-in, first-out (LIFO) inventory of $20 million, cost of goods sold (COGS) of $64 million, and inventory purchases of $58 million. If the LIFO reserve was $6 million at the end of 2006 and $16 million at the end of 2007, compute first-in, first-out (FIFO) inventory at the end of 2007 and FIFO COGS for the year ended 2007.

	FIFO Inventory	FIFO COGS
✗ **A)**	$36 million	$74 million
✗ **B)**	$26 million	$54 million
✓ **C)**	$36 million	$54 million

Explanation

2007 FIFO inventory was $36 million ($20 million LIFO inventory + $16 million reserve). 2007 FIFO COGS was $54 million ($64 million LIFO COGS - $10 million increase in LIFO reserve).

References

Question From: Session 9 > Reading 33 > LOS e

Related Material:

- Key Concepts by LOS

Question #24 of 51

Question ID: 500866

Portsmouth Industries has stated that in the market for their medical imaging product, their strategy is to grow their market share in the premium segment by leveraging their research and development capabilities to produce machines with greater resolution for the most challenging cases of spinal degeneration. An analyst examining their financials for evidence that Portsmouth is indeed successfully pursuing this strategy would *least appropriately* look for:

- ✗ **A)** an increase in net revenue.
- ✓ **B)** decreasing cost of goods sold as a percentage of net sales.
- ✗ **C)** an increase in average unit prices.

Explanation

If Portsmouth is in fact growing their share of the premium market we would expect an increase in unit selling prices as more premium units are sold and an increase in net revenue as sales shift from "regular" to premium machines. COGS may or may not change as percentage of sales if the strategy is successful, but a decrease in COGS would be consistent with a strategy of being the low-cost producer of regular machines.

References

Question From: Session 9 > Reading 33 > LOS a

Related Material:

- Key Concepts by LOS

Question #25 of 51

Question ID: 472416

With regard to a firm's financial reporting quality, an analyst should *most likely* interpret as a warning sign a focus by management on an increase in the firm's:

- ✗ **A)** asset turnover ratios.
- ✓ **B)** pro forma earnings.
- ✗ **C)** cash from operations.

Explanation

One potential warning sign of low-quality financial reporting is management's focus on "pro forma" or non-GAAP measures of earnings. Increases in operating cash flows or asset turnover ratios are not typically viewed as warning signs of poor financial reporting quality.

References

Question From: Session 9 > Reading 32 > LOS g

Related Material:

- Key Concepts by LOS

Question #26 of 51

Question ID: 414693

To adjust for operating leases before calculating financial statement ratios, what value should an analyst add to a firm's liabilities?

- ✗ **A)** Difference between present values of lease payments and the asset's future earnings.
- ✗ **B)** Sum of future operating lease obligations.
- ✓ **C)** Present value of future operating lease payments.

Explanation

Before calculating ratios involving liabilities, an analyst should estimate the present value of operating lease obligations and add this value to the firm's liabilities.

References

Question From: Session 9 > Reading 33 > LOS e

Related Material:

- Key Concepts by LOS

Question #27 of 51

Question ID: 434323

A firm that uses higher estimates of assets' useful lives or salvage values relative to its peers will report:

- ✓ **A)** lower depreciation expense and higher net income.
- ✗ **B)** lower depreciation expense and lower net income.
- ✗ **C)** higher depreciation expense and higher net income.

Explanation

Estimates of useful lives or salvage values that are too high will result in lower depreciation expense and higher net income.

References

Question From: Session 9 > Reading 33 > LOS e

Related Material:

- Key Concepts by LOS

Question #28 of 51

Question ID: 414694

A firm recognizes a goodwill impairment in its most recent financial statement, reducing goodwill from $50 million to $40 million. How should an analyst *most appropriately* adjust this financial statement for goodwill when calculating financial ratios?

- ✗ **A)** Decrease earnings but make no adjustment to assets.
- ✗ **B)** Make no adjustments to assets or earnings because both reflect the impairment.
- ✓ **C)** Decrease assets and increase earnings.

Explanation

The recommended adjustment for goodwill before calculating financial ratios is to remove goodwill from the balance sheet (decreasing assets) and reverse any losses recognized due to goodwill impairment (increasing earnings).

References

Question From: Session 9 > Reading 33 > LOS e

Related Material:

- Key Concepts by LOS

Question #29 of 51

Question ID: 492021

Mechanisms that enforce discipline over financial reporting quality *least likely* include:

- ✓ **A)** accounting standard-setting bodies.
- ✗ **B)** government securities regulators.
- ✗ **C)** counterparties to private contracts.

Explanation

Accounting standard-setting bodies issue financial reporting standards but do not enforce compliance with them. Securities regulators and counterparties to private contracts are among the mechanisms that discipline financial reporting quality.

References

Question From: Session 9 > Reading 32 > LOS f

Related Material:

- Key Concepts by LOS

Question #30 of 51

Question ID: 498766

Which of the following accounting warning signs is *most likely* to indicate manipulation of reported operating cash flows?

✗ **A)** Higher estimated salvage values than are typical in a firm's industry.

✓ **B)** Capitalizing purchases that comparable firms typically expense.

✗ **C)** More aggressive revenue recognition methods than comparable firms.

Explanation

Capitalizing purchases that other firms expense increases reported CFO by classifying the cash outflows as CFI. Revenue recognition methods and accounting estimates may affect reported income but are unlikely to affect the amount or classification of cash flows.

References

Question From: Session 9 > Reading 32 > LOS i

Related Material:

- Key Concepts by LOS

Question #31 of 51

Question ID: 414680

Would projecting future financial performance based on past trends provide a reliable basis for valuation of the following firms?

Firm #1 - A rapidly growing company that has made numerous acquisitions and divestitures.
Firm #2 - A large, well-diversified, company operating in a number of mature industries.

	Firm #1	Firm #2
✓ **A)**	No	Yes
✗ **B)**	Yes	No
✗ **C)**	No	No

Explanation

Using past trends to project future financial performance would be reliable for a well-diversified firm operating in a number of mature industries. The diversified firm would likely have relatively predictable earnings. Using past trends to project future financial performance would not likely be reliable for the rapidly growing firm involved in numerous acquisitions and divestitures. Such a firm would likely have high earnings volatility.

References

Question From: Session 9 > Reading 33 > LOS b

Related Material:

- Key Concepts by LOS

Question #32 of 51

Question ID: 441027

Falcon Financial Group is considering the purchase of Company A or Company B based on a low price-to-book investment strategy that also considers differences in solvency. Selected financial data for both firms, as of December 31, 20X7, follows:

in millions, except per-share data	Company A	Company B
Current assets	$3,000	$5,500
Fixed assets	$5,700	$5,500
Total debt	$2,700	$3,500
Common equity	$6,000	$7,500
Outstanding shares	500	750
Market price per share	$26.00	$22.50

The firms' financial statement footnotes contain the following:

- Company A values its inventory using the first in, first out (FIFO) method.
- Company B's inventory is based on the last in, first out (LIFO) method. Had Company B used FIFO, its inventory would have been $700 million higher.
- Company A leases its manufacturing plant. The remaining operating lease payments total $1,600 million. Discounted at 10%, the present value of the remaining payments is $1,000 million.
- Company B owns its manufacturing plant.

To make the firms financials ratios comparable, calculate the adjusted price-to-book ratios for Company A and Company B.

	Company A	Company B
✓ **A)**	$2.17	$2.06
✗ **B)**	$1.63	$2.06
✗ **C)**	$2.17	$2.81

Explanation

Company A should be adjusted for the operating lease liability and the related assets; however, adding the present value of the lease payments to both assets and liabilities does not change equity (book value). Thus, Company A's adjusted P/B ratio is 2.17 = [$26 price / ($6,000 million equity / 500 million shares)]. Company B's inventory should be adjusted back to FIFO by adding the LIFO reserve to both assets and equity. Thus, Company B's P/B ratio is 2.06 = $22.50 / [($7,500 million equity + $700 million LIFO reserve) / 750 million shares].

References

Question From: Session 9 > Reading 33 > LOS e

Related Material:

- Key Concepts by LOS

Question #33 of 51

Question ID: 414687

Cody Scott would like to screen potential equity investments to identify value stocks and selects firms that have low price-to-sales ratios. Unfortunately, screening stocks based only on this criterion may result in stocks that have poor profitability or high financial leverage, which are undesirable to Scott. Which of the following filters could be added to the stock screen to *best* control for poor profitability and high financial leverage?

Filter #1 - Include only stocks with a debt-to-equity ratio that is above a certain benchmark value.

Filter #2 - Include only dividend paying stocks.

Filter #3 - Include only stocks with an assets-to-equity ratio that is below a certain benchmark value.

Filter #4 - Include only stocks with a positive return-on-equity.

	Poor profitability	High financial leverage
✓ **A)**	Filter #2	Filter #3
✗ **B)**	Filter #4	Filter #3
✗ **C)**	Filter #4	Filter #1

Explanation

Firms that have poor profitability are more likely to be non-dividend paying. Selecting only dividend paying stocks can serve as a check on poor profitability. Using positive ROE to control for poor performance can result in bogus results without additional filters. For example, if both the numerator (net income) and the denominator (average equity) are negative, ROE will be positive. The higher the assets-to-equity ratio, the higher the leverage. Selecting only stocks with an assets-to-equity ratio below a certain cut-off point will eliminate stocks with high leverage. Debt-to-equity above a certain point would include firms with higher, not lower, financial leverage.

References

Question From: Session 9 > Reading 33 > LOS d

Related Material:

- Key Concepts by LOS

Question #34 of 51

Question ID: 414682

For 2007, Morris Company had 73 days of inventory on hand. Morris would like to decrease its days of inventory on hand to 50. Morris' cost of goods sold for 2007 was $100 million. Morris expects cost of goods sold to be $124.1 million in 2008. Assuming a 365 day year, compute the impact on Morris' operating cash flow of the *change* in average inventory for 2008.

- ✓ **A)** $3.0 million source of cash.
- ✗ **B)** $3.0 million use of cash.
- ✗ **C)** $6.3 million source of cash.

Explanation

2007 inventory turnover was 5 (365 / 73 days in inventory). Given inventory turnover and COGS, 2007 average inventory was $20 million ($100 million COGS / 5 inventory turnover). 2008 inventory turnover is expected to be 7.3 (365 / 50 days in inventory). Given expected inventory turnover, 2008 average inventory is $17 million ($124.1 million COGS / 7.3 expected inventory turnover). To achieve 50 days of inventory on hand, average inventory must decline $3 million ($20 million 2007 average inventory - $17 million 2008 expected inventory). A decrease in inventory is a source of cash.

References

Question From: Session 9 > Reading 33 > LOS b

Related Material:

- Key Concepts by LOS

Question #35 of 51

Question ID: 414679

Sterling Company is a start-up technology firm that has been experiencing super-normal growth over the past two years. Selected common-size financial information follows:

	2007 Actual % of Sales	2008 Forecast % of Sales
Sales	100%	100%
Cost of goods sold	60%	55%
Selling and administration expenses	25%	20%
Depreciation expense	10%	10%
Net income	5%	15%
Non-cash operating working capital [a]	20%	25%

[a] Non-cash operating working capital = Receivables + Inventory - Payables

For the year ended 2007, Sterling reported sales of $20 million. Sterling expects that sales will increase 50% in 2008. Ignoring income taxes, what is Sterling's forecast operating cash flow for the year ended 2008, and is this forecast likely to be as reliable as a forecast for a large, well diversified, firm operating in mature industries?

	Operating cash flow	Reliable forecast
✓ **A)**	$4.0 million	No
✗ **B)**	$4.5 million	No
✗ **C)**	$4.0 million	Yes

Explanation

2008 sales are expected to be $30 million ($20 million 2007 sales × 1.5) and 2008 net income is expected to be $4.5 million ($30 million 2008 sales × 15%). 2007 non-cash operating working capital was $4 million ($20 million 2007 sales × 20%) and 2008 non-cash operating working capital is expected to be $7.5 million ($30 million 2008 sales × 25%). 2008 operating cash flow is expected to be $4 million ($4.5 million 2008 net income + $3 million 2008 depreciation - $3.5 million increase in non-cash operating working capital). Forecasts for small firms, start-ups, or firms operating in volatile industries may be less reliable than a forecast for a large, well diversified, firm operating in mature industries.

References

Question From: Session 9 > Reading 33 > LOS b

Related Material:

- Key Concepts by LOS

Question #36 of 51

Question ID: 414684

An analyst makes the following two statements:
Statement #1 - From a lender's perspective, higher volatility of a borrower's profit margins is undesirable for floating-rate debt but not for fixed-rate debt.

Statement #2 - Product and geographic diversification should lower a borrower's credit risk.
With respect to these statements:

- ✗ **A)** both are correct.
- ✗ **B)** both are incorrect.
- ✓ **C)** only one is correct.

Explanation

Margin stability is desirable from the lender's perspective for both floating-rate and fixed-rate debt. Higher volatility will increase credit risk. Product and geographic diversification should lower credit risk as the borrower is less sensitive to adverse events and conditions.

References

Question From: Session 9 > Reading 33 > LOS c

Related Material:

- Key Concepts by LOS

Question #37 of 51

Question ID: 434318

In estimating pro forma cash flows for a company, analysts typically hold which of the following factors constant?

- ✗ **A)** Sales.
- ✓ **B)** Noncash working capital as a percentage of sales.
- ✗ **C)** Repayments of debt.

Explanation

To estimate pro forma cash flows, the analyst must make assumptions about future sources and uses of cash. The most important of these will be increases in working capital, capital expenditures on new fixed assets, issuance or repayments of debt, and issuance or repurchase of stock. A typical assumption is that noncash working capital will remain constant as a percentage of sales.

References

Question From: Session 9 > Reading 33 > LOS b

Related Material:

- Key Concepts by LOS

Question #38 of 51

Question ID: 414677

National Scooter Company and Continental Chopper Company are motorcycle manufacturing companies. National's target market includes consumers that are switching to motorcycles because of the high cost of operating automobiles and they compete on price with other manufacturers. The average age of National's customers is 24 years.

Continental manufactures premium motorcycles and aftermarket accessories and competes on the basis of quality and innovative design. Continental is in the third year of a five-year project to develop a customized hybrid motorcycle. Which of the two firms would most likely report higher gross profit margin, and which firm would most likely report higher operating expense stated as a percentage of total cost?

Higher gross profit margin	Higher percentage operating expense
✗ **A)** Continental	National
✗ **B)** National	Continental
✓ **C)** Continental	Continental

Explanation

Continental likely has the highest gross profit margin percentage since it is selling a customized product and does not compete primarily based on price. Because of the research and development costs of developing a new hybrid motorcycle, Continental likely has the higher operating expense stated as a percentage of total cost.

References

Question From: Session 9 > Reading 33 > LOS a

Related Material:

- Key Concepts by LOS

Question #39 of 51

Question ID: 414685

When assessing credit risk, which of the following ratios would *best* measure a firm's tolerance for additional debt and a firm's operational efficiency?

Ratio #1 - Retained cash flow (CFO - dividends) divided by total debt.
Ratio #2 - Current assets divided by current liabilities.

Ratio #3 - Earnings before interest, taxes, depreciation, and amortization divided by revenues.

	Tolerance for leverage	Operational efficiency
✗ **A)**	Ratio #3	Ratio #1
✓ **B)**	Ratio #1	Ratio #3
✗ **C)**	Ratio #2	Ratio #3

Explanation

A firm's tolerance for additional debt can be measured by its capacity to repay debt. Retained cash flow divided by total debt is one of several measures that can be used. Operational efficiency refers to the firm's cost structure and can be measured by the "margin" ratios. EBITDA divided by sales is one version of an operating margin ratio. The current ratio is a measure of short-term liquidity.

References

Question From: Session 9 > Reading 33 > LOS c

Related Material:

- Key Concepts by LOS

Question #40 of 51

Question ID: 460648

If a firm's financial reports are of low quality, can users of the reports assess the quality of the firm's earnings?

✓ **A)** No, because low-quality financial reports are not useful for assessing the quality of earnings.
✗ **B)** Yes, because users can assess earnings quality independently of financial reporting quality.
✗ **C)** Yes, because if financial reports are of low quality, earnings are also of low quality.

Explanation

Financial reports that are of low quality make it difficult or impossible for users of the statements to assess the quality of the firm's earnings, cash flows, and balance sheet values.

References

Question From: Session 9 > Reading 32 > LOS a

Related Material:

- Key Concepts by LOS

Question #41 of 51

Question ID: 460650

With regard to the goal of neutrality in financial reporting, accounting standards related to research costs and litigation losses should be viewed as:

- ✗ **A)** biased toward aggressive financial reporting.
- ✓ **B)** biased toward conservative financial reporting.
- ✗ **C)** promoting neutral financial reporting.

Explanation

Some accounting principles, such as IFRS and U.S. GAAP standards for expensing research costs and recognizing probable litigation losses, reflect conservatism rather than neutrality, in that they require earlier recognition of probable losses and later recognition of probable gains.

References

Question From: Session 9 > Reading 32 > LOS c

Related Material:

- Key Concepts by LOS

Question #42 of 51

Question ID: 500864

Which of the following is one of circumstances that is conducive to issuing low-quality financial reports?

- ✗ **A)** Balance sheet values are likely to violate debt covenants.
- ✗ **B)** Earnings per share are highly variable from year to year.
- ✓ **C)** There is a large range of acceptable accounting treatments.

Explanation

A large range of acceptable accounting treatments is conducive to manager bias affecting the quality of financial reporting. In such a circumstance, misleading estimates and accounting choices that do not flow from the economic reality of a firm's transactions fall more into the category of mistakes rather than fraudulent reporting. Potentially violating debt covenants is considered a motivation for low quality financial reporting. Variability of earnings could be a motivating factor for earnings smoothing but are not necessarily conducive to low quality financial reporting.

References

Question From: Session 9 > Reading 32 > LOS e

Related Material:

- Key Concepts by LOS

Question #43 of 51

Question ID: 500863

Which of the following is *least likely* to be a motivation for managers to issue financial reports of low quality?

- ✗ **A)** Keeping earnings above the same period in the prior year.
- ✗ **B)** Enhancement of the manager's career.
- ✓ **C)** Accounting controls are weak within the company.

Explanation

Weak accounting controls may offer an opportunity to issue low quality reports but is not in itself a motivation to do so. The other two choices are motivations that might cause management to issue low quality financial reports.

References

Question From: Session 9 > Reading 32 > LOS d

Related Material:

- Key Concepts by LOS

Question #44 of 51

Question ID: 460653

Conditions that may cause firms to issue low-quality financial reports are *best* described as:

- ✗ **A)** unstable organizational structure and deficient internal controls.
- ✗ **B)** inappropriate ethical standards and failing to correct known reportable conditions.
- ✓ **C)** opportunity, motivation, and rationalization.

Explanation

The three conditions that often lead to low-quality financial reporting are opportunity, motivation, and rationalization.

References

Question From: Session 9 > Reading 32 > LOS e

Related Material:

- Key Concepts by LOS

Question #45 of 51

Question ID: 460652

Management is *most likely* to be motivated to produce low-quality financial reports when:

- ✗ **A)** the firm is not required to abide by loan covenants.
- ✗ **B)** managers' compensation is unrelated to the firm's share price.

✓ **C)** earnings are less than analysts expect.

Explanation

Meeting analysts' earnings expectations may motivate management to produce low-quality financial reports. Earning compensation based on the share price and avoiding breaches of loan covenants are also possible motivations.

References

Question From: Session 9 > Reading 32 > LOS d

Related Material:

- Key Concepts by LOS

Question #46 of 51

Question ID: 434320

Other things equal, which of the following firm characteristics are most likely to be viewed favorably by credit rating agencies?

✗ **A)** Large size, diverse product lines, concentrated geographic regions.

✓ **B)** Large size, diverse product lines, many geographic regions.

✗ **C)** Small size, focused product lines, concentrated geographic regions.

Explanation

Other things equal, credit rating agencies tend to rate larger companies and those with diversified product lines and greater geographic diversification to be better credit risks.

References

Question From: Session 9 > Reading 33 > LOS c

Related Material:

- Key Concepts by LOS

Question #47 of 51

Question ID: 460651

Aggressive accounting choices include:

✗ **A)** decreasing the estimated useful life of an asset.

✓ **B)** classifying interest paid as an investing cash flow.

✗ **C)** increasing the valuation allowance of a deferred tax asset.

Explanation

Aggressive accounting choices are those that increase earnings, operating cash flows, or asset values in the current period. Classifying interest paid as an investing cash flow, rather than as an operating cash flow, results in higher CFO and lower CFI. The other choices are examples of conservative accounting choices because they decrease earnings in the current period.

References

Question From: Session 9 > Reading 32 > LOS c

Related Material:

- Key Concepts by LOS

Question #48 of 51

Question ID: 492017

Which of the following is *most accurately* described as a characteristic of a firm's quality of earnings?

- ✗ **A)** Relevance.
- ✓ **B)** Sustainability.
- ✗ **C)** Completeness.

Explanation

Quality of earnings relates to the level and sustainability of a firm's earnings. Relevance and faithful representation (including completeness and neutrality) are characteristics of a firm's financial reporting quality.

References

Question From: Session 9 > Reading 32 > LOS a

Related Material:

- Key Concepts by LOS

Question #49 of 51

Question ID: 456303

Samantha Cameron, CFA, is analyzing the financial reporting quality of Redd Networks. Cameron examines how the company is responding to strict debt covenants and investigates executives' holdings of stock and options in the firm, which are believed to be quite high. Which condition that may lead to low-quality financial reporting is Cameron investigating?

- ✓ **A)** Motivation.
- ✗ **B)** Opportunity.
- ✗ **C)** Rationalization.

Explanation

The issues Cameron is investigating represent incentives that may lead to low-quality financial reporting.

References

Question From: Session 9 > Reading 32 > LOS e

Related Material:

- Key Concepts by LOS

Question #50 of 51

Question ID: 434322

LIFO ending inventory can be adjusted to a FIFO basis by:

✗ **A)** adding the change in the LIFO reserve.

✓ **B)** adding the LIFO reserve.

✗ **C)** subtracting the change in the LIFO reserve.

Explanation

LIFO ending inventory can be adjusted to a FIFO basis by adding the LIFO reserve, which a firm using LIFO must disclose in the notes to its financial statements.

References

Question From: Session 9 > Reading 33 > LOS e

Related Material:

- Key Concepts by LOS

Question #51 of 51

Question ID: 460649

Aggressive accounting choices by management are *most likely* to:

✗ **A)** report sustainable earnings.

✓ **B)** comply with generally accepted accounting principles.

✗ **C)** produce decision-useful financial reporting.

Explanation

Management may follow generally accepted accounting principles and still make biased (i.e., aggressive or conservative) accounting choices. Biased accounting choices diminish the decision-usefulness of financial reporting. Aggressive accounting choices are those that increase earnings, revenues, or operating cash flows in the current period (and likely reduce them in later periods).

References

Question From: Session 9 > Reading 32 > LOS c

Related Material:

- Key Concepts by LOS