

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

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.
-

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.
-

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.
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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.
-

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.
-

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?

- | <u>Inventory method</u> | <u>Depreciation method</u> |
|-------------------------|----------------------------|
| A) Last-in, First-out | Accelerated |
| B) First-in, First-out | Straight-line |
| C) First-in, First-out | Accelerated |
-

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.
-

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.
-

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.
-

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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.
-

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.

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.
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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.
-

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.
-

Question #15 of 51

Question ID: 414681

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

<i>in millions</i>	<i>% of Sales</i>	
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.

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.

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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:

<u>FIFO ending inventory</u>	<u>FIFO after-tax profit</u>
------------------------------	------------------------------

- | | |
|-------------|---------|
| A) \$26,000 | \$2,600 |
| B) \$18,000 | \$2,600 |
| C) \$26,000 | \$1,400 |

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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.

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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.

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.

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.
-

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.
-

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
-

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.

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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.
-

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.
-

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.
-

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.
-

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.
-

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.
-

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.

- | | <u>Firm #1</u> | <u>Firm #2</u> |
|--------|----------------|----------------|
| A) No | | Yes |
| B) Yes | Yes | No |
| C) No | No | No |
-

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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:

<i>in millions, except per-share data</i>	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 financial ratios comparable, calculate the adjusted price-to-book ratios for Company A and Company B.

	<u>Company A</u>	<u>Company B</u>
A)	\$2.17	\$2.06
B)	\$1.63	\$2.06
C)	\$2.17	\$2.81

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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.

	<u>Poor profitability</u>	<u>High financial leverage</u>
A)	Filter #2	Filter #3
B)	Filter #4	Filter #3
C)	Filter #4	Filter #1

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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.

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	<u>10%</u>	<u>10%</u>
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?

- | <u>Operating cash flow</u> | <u>Reliable forecast</u> |
|----------------------------|--------------------------|
| A) \$4.0 million | No |
| B) \$4.5 million | No |
| C) \$4.0 million | Yes |

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.
-

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.
-

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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?

<u>Higher gross profit margin</u>	<u>Higher percentage operating expense</u>
-----------------------------------	--

- | | |
|----------------|-------------|
| A) Continental | National |
| B) National | Continental |
| C) Continental | Continental |
-

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 |
-

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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.
-

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.
-

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.
-

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.
-

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.
-

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.
-

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.

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.

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.

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.

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.

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.