Chapter 02
Financial Reporting and Analysis

1. Which would be issued by auditors where there is a history of significant losses coupled with uncertain prospects?
A. An "except for" qualification
B. An adverse opinion
C. A disclaimer of opinion
D. An audit warning

2. Which of the following would require the filing of Form 8-K?
I. Major acquisition
II. Audited financial statements
III. Bankruptcy
IV. Change in management control
A. I and III
B. II and IV
C. I, III and IV
D. I, II, III and IV

3. Which of the following is *not* considered part of GAAP?
A. Statements of Financial Accounting Standards (SFAS)
B. International Accounting Standards (IAS)
C. Accounting Research Bulletins (ARB).
D. Accounting Principles Board Opinions (APB).

4. Which of the following is not considered a monitoring mechanism?
A. The Securities and Exchange Commission (SEC)
B. Top level management
C. The board of director's audit committee
D. The external auditors

5. Which of the following statements about directors of a company is *true*?
A. Directors are elected by management of a company.
B. Directors only get paid if the company increases its profitability that year.
C. Directors are shareholders' representatives.
D. All directors of a company are senior managers in that company.

6. Which of the following statements about accruals and cash flows is *true*?
A. All cash flows are value relevant.
B. Cash flows cannot be manipulated.
C. Cash flows are more reliable than accruals.
D. All accrual accounting adjustments are value irrelevant.

7. Which of the following statements about accruals and cash flows is *false*?
A. Company value can be determined by using accrual accounting numbers.
B. Accrual accounting numbers are subject to accounting distortions.
C. Cash flows are more reliable than accruals.
D. Cash flows cannot be manipulated.

8. The two primary qualities of accounting information to make it useful for decision making are:
A. reliability and comparability.
B. relevance and reliability.
C. materiality and comparability.
D. full disclosure and relevance.

9. Financial accounting data has some inherent limitations. Which of the following are limitations?
I. Not all economic events are easily quantifiable.
II. Many accounting entries rely heavily on estimates.
III. Historical cost can distort statements.
IV. Inflation can distort accounting data.
A. I, II and III
B. I, III and IV
C. II, III and IV
D. I, II, III and IV

10. Audit risk represents a danger to users of audited financial statements. The following are attributes pointing to potential areas of vulnerability except
A. company in financial distress requiring financing.
B. management dominated by one or more strong-willed individuals.
C. deterioration in liquidity or solvency.
D. company earning high profits consistently over a number of years.

11. If a company fails to record a material amount of depreciation in a previous year, this is considered:
A. a change in accounting principle.
B. an unusual item.
C. an accounting error.
D. a change in estimate.

12. Which of the following are examples of judgments made in the accounting reporting process?
I. Useful life of machinery
II. Allowance for doubtful accounts
III. Obsolescence of assets
IV. Interest payment on bonds
A. I, II, III and IV
B. I, II and III
C. II and III
D. I and III

13. Which of the following would affect the comparability of accounting information for a given company from one accounting period to the next?
I. Change in accounting principles
II. Disposition of segment of business
III. Restructuring expenses
IV. Change in auditors
A. I and II
B. I and III
C. I, II and III
D. I, III and IV

14. Which of the following would affect the comparison of financial statements across two different firms?
I. Different accounting principles
II. Different sizes of the companies
III. Different reporting periods
IV. Different industries
A. I, III and IV
B. I and IV
C. I and II
D. I, II, III and IV

Byfort Company reports the following in its financial statements:

	2005	2006
Accounts Receivable, net	$ 34,289K	$ 29,678K
Net sales	$360,007K	$450,000K

*All sales are on credit.

15. How much did the company collect in cash from debtors during 2006?
A. $445,389K
B. $454,611K
C. $484,289K
D. $488,900K

16. How much sales would have been reported by the company in 2006 if Byfort would have been using cash accounting and not accrual accounting?
A. $445,389K
B. $454,611K
C. $484,289K
D. $488,900K

17. 10-K reports are:
A. the quarterly reports to stockholders.
B. quarterly filings made by a company with the SEC.
C. annual filings made by a company with SEC.
D. filings made by a company with SEC when a company changes auditors.

18. The management of Finner Company believes that "the statement of cash flows is not a very useful statement" and does not include it with the company's financial statements. As a result the auditor's opinion should be:
A. qualified.
B. unqualified.
C. adverse.
D. disclaimed.

19. Which of the following statements is *incorrect*?
A. Under GAAP, statements are prepared using accrual accounting.
B. Under GAAP, all assets are marked to market each accounting period.
C. Under GAAP, it is necessary to make certain estimates.
D. Annual statements submitted to the SEC (10-K) must be prepared using GAAP.

20. When analyzing financial statements it is important to recognize that accounting distortions can arise. Accounting distortions are those things that cause deviations in accounting information from the underlying economics. Which of the following statements is *not* correct? Accounting distortions:
A. can arise as management may deliberately manipulate financial statements.
B. arise often through application of (correct) accounting principles.
C. can affect the quality of earnings.
D. arise if the stock market is not efficient.

21. Which of the following is a change in an accounting estimate?
I. A change from straight line depreciation to an accelerated depreciation method.
II. A change in estimated salvage value of depreciable asset.
III. A change in estimated useful life of an asset.
IV. Recording depreciation for the first time on machinery purchased five years ago.
A. I, II, III and IV
B. II, III and IV
C. I, III and IV
D. II and III

22. Which of the following are changes in accounting principle?
I. A change from LIFO to FIFO.
II. A change in estimated salvage value of depreciable asset.
III. A change from an accelerated depreciation method to straight line depreciation.
IV. Recording depreciation for the first time on machinery purchased five years ago.
A. I, II, III and IV
B. I, II and III
C. I, III and IV
D. I and III

23. Which of the following is *not* a source of industry information?
A. SEC manuals
B. Standard and Poor's
C. Trade journals
D. Robert Morris Associates

24. Which of the following information would *not* be filed with the SEC by a publicly traded company?
A. 10-K report
B. Prospectus
C. Proxy statement
D. Tax return

25. Accounting Standards are best described as:
A. the result of a political process among groups with diverse interests.
B. presentation standards mandated by the Securities and Exchange Commission.
C. the state-of-the-art presentation of the science of accounting.
D. measuring the quality of safeguarding assets.

26. The matching principle requires that:
A. revenues earned and expenses incurred in generating those revenues should be reported in the same income statement.
B. non-operating gains and losses should be netted against each other.
C. a proportion of each dollar collected will be assumed to be a recovery of cost.
D. assets will be matched to the liabilities incurred to purchase them.

27. If a company changes auditors, it is required to file the following with the SEC:
A. 10-K
B. 10-Q
C. 8-K
D. S-1

28. The primary responsibility for fair and accurate financial reporting rests with the:
A. board of directors.
B. SEC.
C. management.
D. auditors.

29. Which of the following is *incorrect?* When using the 10-Q, the analyst should be aware that the usefulness of the quarterly financial statements might be affected by:
A. seasonality.
B. adjustments made in the final quarter of the year.
C. the use of cash accounting.
D. the increased use of estimates.

30. Voluntary disclosure by managers is becoming an increasingly important source of information. Which of the following is *least likely* to be a reason for this increased disclosure?
A. Protection under Safe Harbor Rules.
B. To manage investors' expectations.
C. To signal information to investors.
D. To respond to increased demands by labor unions.

31. The two *secondary* qualities of accounting information to make it useful for decision making are:
A. consistency and comparability.
B. relevance and reliability.
C. materiality and comparability.
D. full disclosure and relevance.

32. Economic income measures change in:
A. asset value.
B. liability value.
C. shareholder value.
D. net cash flows.

33. Which one of the following is *not* an example of a red flag, used to evaluate earnings quality?
A. Qualified audit report
B. Net income this year is higher then net income last year
C. Poor financial performance
D. Frequent or unexplained changes in accounting policies

34. Economic income includes:
A. recurring components only.
B. nonrecurring components only.
C. both recurring and nonrecurring components.
D. neither recurring nor nonrecurring components.

35. For a going concern, company value can be expressed by:
A. dividing permanent income by the cost of capital.
B. multiplying permanent income by the cost of capital.
C. dividing permanent income by the market value per share.
D. multiplying permanent income by the market value per share.

36. Accounting income consists of all the following components except:
A. permanent component.
B. transitory component.
C. value irrelevant component.
D. temporary component.

37. To determine a company's sustainable earning power, an analyst needs to first determine the recurring component of the current period's accounting income by excluding nonrecurring components of accounting income. Such adjusted earnings are often referred to as:
A. core earnings.
B. permanent earnings.
C. basic earnings.
D. operating earnings.

38. SFAS 157 defines fair value as the:
A. market price.
B. exchange price.
C. net asset value.
D. real value.

39. SFAS prescribes that information about the level of inputs used for determining fair values must be reported in the:
A. balance sheet.
B. director's letter.
C. footnotes.
D. MD&A.

40. All of the following are basic approaches to valuation except:
A. market approach.
B. asset approach.
C. income approach.
D. cost approach.

41. GAAP stands for General American Accounting Principles, and must be adhered to by publicly traded companies when preparing their financial statements.
FALSE

42. FASB stands for Financial Accounting Service Bureau, and is a sub-division of the Securities and Exchange Commission (SEC).
FALSE

43. Under GAAP accounting, a company has the choice of using cash or accrual accounting in preparing its financial statements.
FALSE

44. Under cash accounting, a company must recognize revenues in financial statements when the revenues are earned or realized.
FALSE

45. Under accrual accounting, a company will recognize expenses as they are paid.
FALSE

46. Accrual income is a better predictor of future cash flows than current cash flows.
TRUE

47. The auditor provides "reasonable", as opposed to "absolute" assurance that the financial statements provide no material misstatement.
TRUE

48. Net income is usually higher than free cash flows.
TRUE

49. By using earnings management, managers always try to increase income.
FALSE

50. Income smoothing is a form of earnings management.
TRUE

51. Income shifting is not one of the earnings management mechanics.
FALSE

52. The development of the financial statements is management's responsibility and the auditor is not concerned with the process of development.
FALSE

53. Accounting information is "material" if its omission would cause a reasonable person to make a different decision if the information was included.
TRUE

54. Accounting distortions arise from the nature of accrual accounting.
TRUE

55. Primary responsibility for fair and accurate financial statements rests with the auditors.
FALSE

56. Audits are designed and implemented with the objective of detecting fraud.
FALSE

57. Accounting standards issued by the SEC are applicable to all US companies being audited.
FALSE

58. The "big bath" strategy is often used in conjunction with an income-increasing strategy for other years.
TRUE

59. Accounting standards are set by the American Institute of Certified Public Accountants (AICPA).
FALSE

60. The Securities and Exchange Commission (SEC) has the power to issue accounting standards, but generally defers this responsibility to the Financial Accounting Standards Board (FASB).
TRUE

61. Accrual accounting overcomes both the timing and the matching problems that are inherent in cash accounting.
TRUE

62. FASB has recognized the conceptual superiority of the historical value concept and has, in principle, decided to eventually move to a model where all asset and liability values are recorded at fair value.
FALSE

63. Accounting or reported income is same as economic income.
FALSE

64. Operating income is often referred to as net operating profit before tax.
FALSE

65. Accounting income attempts to capture elements of both permanent income and economic income, but with measurement error.
TRUE

66. Operating earnings includes all revenue and expense components that pertain to the company's operating business, regardless of whether they are recurring or nonrecurring.
TRUE

67. Under the fair value model, income is determined by matching costs to recognized revenues, which have to be realized and earned.
FALSE

68. The fair value of an asset is the hypothetical price at which a business can sell the asset (exit price).
TRUE

69. **Problem One: Motivation to Manipulate Financial Results**
There are many ways in which the management of a company can manage the reported earnings. Give three reasons why management may want to manage earnings being sure to explain your answer in full.

Problem One: Motivation to Manipulate Financial Results
(a) Contracting incentives:
Many contracts use accounting numbers. Management compensation contracts may have a bonus formula based upon earnings and other metrics. Management may have an incentive to boost earnings in order to reach a specified target. If real earnings exceed the formula limits, the management has an incentive to reduce earnings, banking the extra income for the following year(s).
Other contracts will also create incentives for earnings management. Management may stretch earnings in order to avoid violating a debt covenant.
(b) Stock price effects:
Higher stock prices benefit executives with stock options.
Higher prices are useful for acquisitions and security offerings.
Smooth earnings growth and beating market expectations each quarter are important objectives when managing earnings. They reduce the market's perception of risk and decreases the company's cost of capital.
Suppliers and customers like dealing with a successful company.
(c) Other Incentives:
Reduced earnings may be useful for regulatory and political purposes. For example, a utility company showing lower earnings might have a stronger case when seeking rate increase approvals from a regulatory authority. Or a steel company could exaggerate the effect of cheap foreign imports when requesting tariff protection.
Reduced earnings aid management when confronting labor union demands.
Use of a big bath write-off by a new management team clears the way for future earnings increases and signals to the market that the new team is making the tough decisions.

70. **Problem Two: Earnings Management**
Earnings management can be defined as the "purposeful intervention by management in the earnings process, usually to satisfy selfish objectives" (Schipper, 1989).
Earnings management techniques can be separated into those that are "cosmetic" (without cash flow consequences) and those that are "real" (with cash flow consequences).
The management of a company wishes to increase earnings this period.
List three "cosmetic" and three "real" techniques that can be used to achieve this objective and explain why they will achieve the objective.

Problem Two: Earnings Management
Cosmetic (non-cash flow) techniques would be:
● Decrease estimated bad debt expense
● Decrease estimated warrantee expense
● Increase in estimated salvage value of depreciable assets
● Increase discount rate on pension plans
● Increase expected rate of return on pension assets
● Change from accelerated depreciation to straight line depreciation
● Capitalize expenses such as software development and R&D
Real changes would be:
● Decrease R&D expenditures
● Decrease advertising expenditures
● Decrease maintenance spending
● Changing accounting principle from LIFO to FIFO (assuming rising prices). Note that this will have a tax effect, as one cannot use FIFO for financial reporting purposes and LIFO for tax purposes.
● Channel loading (i.e. borrowing sales from the next period, which if repeated usually escalates in future periods)

71. **Problem Three: Identifying red flags**
One step in assessing the quality of earnings is to look for red flags. An example of a red flag is a significant increase in accounts receivable without commensurate growth in sales (that is, accounts receivable turnover decreases). List five other red flags an astute analyst might look for. Also, provide the reason for it being a red flag, and identify where the analyst might find this information.

Problem Three: Identifying red flags
Possible red flags
1. Decrease in inventory turnover – calculated from financial statements. This may indicate obsolete or unsalable goods.
2. Change in auditors. A parting of the ways with auditors may be because of disagreements over accounting matters. This will be filed in an 8-K report.
3. Qualified audit report
4. Frequent changes in accounting principles – this may be an attempt at earnings management and information can be found in auditor's letter and footnotes.
5. Reported net income is consistently higher than operating cash flow. Unless the company is growing fast for long periods this may indicate inflated earnings.
6. Reported net income is consistently higher than taxable income. Taxable income is not reported but we can infer whether it is higher or lower and by how much from the size of the deferred taxes. Consistently large deferred tax liabilities could be a signal of red flags.
7. Poor financial performance. Desperate companies are prone to desperate means and their managements are subject to temptation.
8. Frequent one-time charges and big baths. These may indicate significant underlying problems.
9. Significant and/or frequent changes in corporate management. Departures of officers and directors may be indicative of important corporate issues. The proxy, press releases, business publications and 8-K filings may contain this information.
10. Use of financing mechanisms. Off balance sheet financings such as operating leases, securitization of assets, special purpose entities, etc. may be proper but can also be used to excess or to cover cash shortfalls. Footnotes and the MD&A should describe these situations.
11. Related party transactions and relationships. Unusual transactions (if disclosed) between management and the company (such as Adelphia Communications' guarantee of loans to the controlling Rigas family and Worldcom's extension of loans to its CEO Bernie Ebbers) indicate conflicts of interest, potential for abuses and self dealing, often prefacing financial difficulties for the company. Similarly, a board of directors with few independent directors is less likely to protect the interests of outside shareholders. The proxy statement is a particularly good place to catch these disclosures.

12. Incomprehensible disclosures. Some disclosures are so convoluted that it is just impossible to make heads or tails out of them. Looking back, with the benefit of hindsight, Enron's SPE disclosures contained interesting clues and warning signs. Increasingly, companies take pains to clearly explain complex situations so that the reader may take some comfort.
13. Last minute transactions. Transactions that take place at the end of the reporting period may be used to make up for the poor results that would otherwise have been achieved.

72. **<u>Problem Four: Discretionary Expenditures</u>**
Discretionary expenditures are outlays that management can vary across periods to conserve resources and/or manage earnings. Give three examples and explain their potential impact on earnings quality when analyzing a company.

Problem Four: Discretionary Expenditures
Advertising, selling and marketing expense cutbacks can penalize future sales. In contrast, a huge new ad campaign or expansion of the sales force may benefit the following year.
R&D, while extremely difficult to evaluate, is generally considered important to future success, especially in high technology companies. There can be numerous successful research and development activities, but for each successful project, there can be countless failures. It is important to determine the amount of current research and development costs having future benefits.
Repairs and maintenance expenses, if insufficient, may lead to higher production costs or even the premature replacement of equipment.
Expenditure on training and managerial development programs are other discretionary future-directed outlays.

73. **Problem Five: Balance Sheet Analysis of Earnings Quality**
The relevance of reported asset values is linked (with few exceptions like cash, held-to-maturity investments and land) with their ultimate recognition as reported expenses. Provisions and liability values on the balance sheet may also affect earnings quality. For each of the following give an example and explain its impact upon cumulative earnings.
a. An overstated asset
b. An understated asset
c. An overstated liability or provision
d. An understated liability or provision

Problem Five: Balance Sheet Analysis of Earnings Quality
a. When an asset is overstated. earnings are overstated. Examples: the delay in recognizing impaired assets, such as obsolete inventories or unproductive plant and equipment and understatement of allowance for uncollectible accounts receivable,
b. When an asset is understated, earnings are understated. Examples: unrecognized appreciation on an acquired business that is recorded at original purchase price, excessive depreciation or amortization (short life or low salvage value).
c. When a liability or provision is overstated. earnings are understated. Examples: overestimation of severance costs for a planned restructuring,
d. When a liability or provision is understated, earnings are overstated. Examples: understatements in provisions for product warranties, environmental liabilities, subscription liabilities.

74. **Problem Six: Fair Value Accounting**
ABC Co. starts its business raising $110,000 in cash; $60,000 from issuing equity and $50,000 from issuing 6% bonds at par. ABC used the whole amount of cash to buy a building, which it rents out for $10,000 per year. Given below is the opening balance sheet of ABC Co. for the first year of operations.

	Year 1
Assets	
Cash	0
Building	110000
	110000
Liabilities and Shareholder's equity	
Long-term debt	50000
Shareholders' equity	60000
	110000

At the end of Year 1, the building is valued at $150,000. Also, the market value of bonds has fallen to $49,000. Assume the useful life of the building is 30 years and its salvage value is $50,000 at the end of that period. The rental income is received on the last day of the year. Interest on bonds is also paid on this day.
Prepare the year-end balance sheet and income statement of ABC Co. based on *Fair value.* Compare the historical and fair values at year-end.

Problem Six: Fair Value Accounting

	Year 1	
	Historical cost	Fair Value
Assets		
Cash*	$ 7,000	$ 7,000
Building	108,000	150,000
	$ 115,000	$ 157,000
Liabilities and Shareholder's equity		
Long-term debt	$ 50,000	$ 49,000
Shareholders' equity	65,000	108,000
	$ 115,000	$ 157,000
Income Statement		
Rental income	$ 10,000	$ 10,000
Depreciation	(2,000)	
Interest expense	(3,000)	(3,000)
Unrealized gain/loss on condo		40,000
Unrealized gain/loss on debt		1,000
Income (loss)	$ 5,000	$ 48,000

*Rental income received	$10,000
Interest paid on bonds	3,000
Cash in hand	**7,000**

$$\text{Depreciation on building} = \frac{\text{Cost} - \text{salvage value}}{\text{Number of years}}$$

$$= \frac{\$110{,}000 - 50000}{30}$$

$$= \$2{,}000$$

Notice that under fair value method, all assets and liabilities are considered at their market value. Fair value accounting does not consider any depreciation on fixed assets. It recognizes any unrealized gain or loss on assets or long-term debt on account of change in market value.