Question #1 of 28

Question ID: 1573675

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 compliant with GAAP but reporting choices and estimates are biased. ✗

C) Reporting is not compliant with GAAP but the numbers presented reflect the company's actual activities. ✗

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.

(Module 38.1, LOS 38.b)

Question #2 of 28

Question ID: 1573677

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 not compliant and includes numbers that are fictitious or fraudulent. ✗

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

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.

(Module 38.1, LOS 38.b)

Question #3 of 28

Question ID: 1573695

Compared to a firm that appropriately expenses recurring maintenance costs, a firm that capitalizes these costs will report greater cash flow from:

A) operating activities.

B) financing activities.

C) investing activities.

Explanation

When a firm capitalizes costs, it classifies the cash outflow as CFI rather than CFO. The result is higher CFO compared to expensing the same costs.

(Module 38.2, LOS 38.g)

Question #4 of 28

Question ID: 1573699

An analyst would *most likely* suspect that the quality of a company's earnings is deteriorating if the company:

A) has an operating cash flow to net income ratio greater than one.

B) increases the estimated useful lives and salvage values of several physical assets.

C) has substantial changes in management's commentary every reporting period.

Explanation

Management can boost reported earnings by increasing estimates of useful lives and salvage values for the company's depreciable assets. Both will increase reported earnings by reducing depreciation expense. Choices that increase reported earnings are generally considered to decrease the quality of reported earnings.

If the ratio of operating cash flow to net income is *less* than 1.0 consistently, the company is reporting higher earnings than are likely to be supportable by its operating performance. Management's commentary *should* change every reporting period. Commentary that is similar across periods suggests management is lax in its responsibility for financial reporting. (Module 38.3, LOS 38.h)

Question #5 of 28

Question ID: 1573684

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) Opportunity.

B) Rationalization.

C) Motivation.

Explanation

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

(Module 38.1, LOS 38.d)

Question #6 of 28

Question ID: 1573698

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

A) Capitalizing purchases that comparable firms typically expense.

B) Higher estimated salvage values than are typical in a firm's industry.

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.

(Module 38.3, LOS 38.h)

Question #7 of 28

Question ID: 1573692

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.

(Module 38.2, LOS 38.g)

Question #8 of 28

Question ID: 1573696

If a firm's management wants to use its discretion over accounting choices to increase operating income in the next period, they are *most likely* to:

A) write up plant and equipment from depreciated cost to its fair market value.

B) increase the assumed residual values of plant and equipment.

C) decrease the assumed useful lives of plant and equipment.

Explanation

Increasing residual values of plant and equipment would decrease depreciation expense and increase operating income. Decreasing the useful lives of plant and equipment would increase depreciation expense by depreciating these assets over a shorter period. Under IFRS, the firm cannot recognize revaluation above depreciated cost on the income statement unless it reverses a previously recognized loss. Increasing the book value of plant and equipment would also increase depreciation expense in subsequent periods.

(Module 38.2, LOS 38.g)

Question #9 of 28

Question ID: 1573685

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

A) opportunity, motivation, and rationalization.

B) unstable organizational structure and deficient internal controls.

C) inappropriate ethical standards and failing to correct known reportable conditions.

Explanation

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

(Module 38.1, LOS 38.d)

Question #10 of 28

Question ID: 1573683

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

A) Accounting controls are weak within the company.

B) Enhancement of the manager’s career.

C) Keeping earnings above the same period in the prior year.

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.

(Module 38.1, LOS 38.d)

Question #11 of 28

Question ID: 1573673

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

A) Sustainability.

B) Completeness.

C) Relevance.

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.

(Module 38.1, LOS 38.a)

Question #12 of 28

Question ID: 1573691

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) show this measure for all periods presented.

B) define and explain the relevance of this measure.

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.

(Module 38.1, LOS 38.f)

Question #13 of 28

Question ID: 1573679

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.

(Module 38.1, LOS 38.c)

Question #14 of 28

Question ID: 1573680

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

A) managers' compensation is unrelated to the firm's share price.

B) the firm is not required to abide by loan covenants.

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.

(Module 38.1, LOS 38.d)

Question #15 of 28

Question ID: 1573687

While motivation and opportunity both can lead to low quality of financial reporting, a third important contributing factor is:

A) rationalization of the actions.

B) pressure to meet earnings expectations.

C) poor financial controls.

Explanation

A mindset that allows rationalization is the third important condition underlying low-quality financial reporting. Poor financial controls are an example of opportunity and pressure to meet earnings expectations is a possible motivation. (Module 38.1, LOS 38.d)

Question #16 of 28

Question ID: 1573689

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) management must attest to the effectiveness of the firm’s internal controls.

B) the firm must provide a signed statement by the person responsible for preparing the financial statements.

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.

(Module 38.1, LOS 38.e)

Question #17 of 28

Question ID: 1573682

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

A) Debt covenants.

B) Disclosure regulations.

C) Audit requirements.

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.

(Module 38.1, LOS 38.d)

Question #18 of 28

Question ID: 1573686

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

A) Earnings per share are highly variable from year to year.

B) There is a large range of acceptable accounting treatments.

C) Balance sheet values are likely to violate debt covenants.

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.

(Module 38.1, LOS 38.d)

Question #19 of 28

Question ID: 1573674

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.

(Module 38.1, LOS 38.a)

Question #20 of 28

Question ID: 1573690

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) pro forma earnings.

B) cash from operations.

C) asset turnover ratios.

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.

(Module 38.1, LOS 38.f)

Question #21 of 28

Question ID: 1573678

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

A) produce decision-useful financial reporting.

B) report sustainable earnings.

C) comply with generally accepted accounting principles.

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).

(Module 38.1, LOS 38.c)

Question #22 of 28

Question ID: 1573697

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.

(Module 38.3, LOS 38.h)

Question #23 of 28

Question ID: 1573676

A spectrum for assessing financial reporting quality should consider:

A) quality of earnings only.

B) both quality of financial reports and quality of earnings.

C) quality of financial reports only.

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.

(Module 38.1, LOS 38.b)

Question #24 of 28

Question ID: 1573688

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

A) government securities regulators.

B) counterparties to private contracts.

C) accounting standard-setting bodies.

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.

(Module 38.1, LOS 38.e)

Question #25 of 28

Question ID: 1573672

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.

(Module 38.1, LOS 38.a)

Question #26 of 28

Question ID: 1573693

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) understate assets.

B) overstate earnings.

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.

(Module 38.2, LOS 38.g)

Question #27 of 28

Question ID: 1573694

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

A) Decreasing the salvage value of depreciable assets.

B) Recognizing revenue before fulfilling the terms of a sale.

C) Selling more inventory than is purchased or produced.

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.

(Module 38.2, LOS 38.g)

Question #28 of 28

Question ID: 1573681

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

A) Management's compensation is closely tied to near-term performance of the firm's stock.

B) The firm must meet accounting benchmarks to comply with debt covenants.

C) Earnings for a period will be higher than analysts' expectations.

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.

(Module 38.1, LOS 38.d)