Question 1

L2R21TB-AC018-1512

LOS: LOS-7150

Lesson Reference: Lesson 1: Quality of Financial Reports

Difficulty: medium

Accounting choices that are *most likely* to affect only a single financial statement are those pertaining to:

- (selected) Classification.
- Recorded amounts.
- Timing of recognition.

Rationale

✔ **Classification.**

Choices with respect to where the firm records the amount as to classification (e.g., notes receivable rather than accounts receivable) typically affect only a single financial statement, but improve the appearance of the actual result (e.g., lower days of sales outstanding or increased receivables turnover).

Rationale

✘ **Recorded amounts.**

Choices with respect to where the firm records the amount as to classification (e.g., notes receivable rather than accounts receivable) typically affect only a single financial statement, but improve the appearance of the actual result (e.g., lower days of sales outstanding or increased receivables turnover).

Rationale

✘ **Timing of recognition.**

Choices with respect to where the firm records the amount as to classification (e.g., notes receivable rather than accounts receivable) typically affect only a single financial statement, but improve the appearance of the actual result (e.g., lower days of sales outstanding or increased receivables turnover).

Question 2

L2R21TB-AC024-1512

LOS: LOS-7210

Lesson Reference: Lesson 3: Earnings Quality

Difficulty: medium

Large loss accruals for foreseeable environmental remediation would *most likely* indicate:

- (selected) Past earnings overstatement.
- Past expense overstatement.
- No real problem, because results going forward will be more accurate.

Rationale

✔ **Past earnings overstatement.**

Because the firm did not accrue for potential remediation, expenses were understated and earnings overstated; that is, they did not accurately reflect economic reality.

Rationale

✖ **Past expense overstatement.**

Because the firm did not accrue for potential remediation, expenses were understated and earnings overstated; that is, they did not accurately reflect economic reality.

Rationale

✖ **No real problem, because results going forward will be more accurate.**

Because the firm did not accrue for potential remediation, expenses were understated and earnings overstated; that is, they did not accurately reflect economic reality.

Question 3
L2R21TB-AC010-1512
LOS: LOS-7190
Lesson Reference: Lesson 3: Earnings Quality
Difficulty: medium

An analyst is reviewing two companies for potential accounting manipulation designed to increase operating cash flows:

> Company A—Expensed rather than capitalized certain expenses that could legitimately be capitalized.
> Company B—Recorded the gain from a long-term asset sale as an increase to operating earnings.

Which company will *most likely* appear to increase earnings quality via higher cash flow from operations?

- ○ Only Company A.
- ◉ Only Company B.
- ○ Neither Company A nor Company B.

Rationale
✗ Only Company A.
Expensing rather than capitalizing reduces operating cash flow (rather than reducing investing cash flow). Normally, a gain from a long-term asset sale is reported in net income, but does not affect operating earnings. Therefore, by treating the asset sale as a part of operating earnings, which then benefits operating cash flow, only Company B appears to be manipulating an improvement in operating cash flow.

Rationale
✓ Only Company B.
Expensing rather than capitalizing reduces operating cash flow (rather than reducing investing cash flow). Normally, a gain from a long-term asset sale is reported in net income, but does not affect operating earnings. Therefore, by treating the asset sale as a part of operating earnings, which then benefits operating cash flow, only Company B appears to be manipulating an improvement in operating cash flow.

Rationale
✗ Neither Company A nor Company B.
Expensing rather than capitalizing reduces operating cash flow (rather than reducing investing cash flow). Normally, a gain from a long-term asset sale is reported in net income, but does not affect operating earnings. Therefore, by treating the asset sale as a part of operating earnings, which then benefits operating cash flow, only Company B appears to be manipulating an improvement in operating cash flow.

Question 4
L2R21TB-ITEMSET-AC001-1512
LOS: LOS-7160
LOS: LOS-7170
Lesson Reference: Lesson 2: Evaluating the Quality of Financial Reports
Difficulty: medium

Use the following information to answer the next three questions:

Salina Cho utilizes a fundamental approach to selecting equity securities for a large, multinational mutual fund company. Prior to completing a more detailed analysis of financial performance of Philbin Corp., Cho looks at the probability of earnings manipulation using the Beneish M-score model. The model is as follows:

$$\mathrm{M-score} = -4.84 + 0.920\,\mathrm{DSR} + 0.528\,\mathrm{GMI} + 0.404\,\mathrm{AQI} + 0.892\,\mathrm{SGI} + 0.115\,\mathrm{DEPI} - 0.172\,\mathrm{SGAI}\ + 4.670\,(\mathrm{Accruals}) - 0.327(\mathrm{LEVI})$$

The M-score for Philbin was calculated to be –3.78.

Prior to continuing her analysis, Cho discusses the results with Ed Markowitz, Director of Research. During their conversation, Cho makes the following statements to Markowitz:

> **Statement 1:** The sales growth index (SGI) value was slightly greater than 1, indicating sales in the current period were greater than in the prior period.
> **Statement 2:** The asset quality index (AQI) value was slightly greater than 1, indicating a higher percentage of total assets that were not in property, plant and equipment (PP&E) or current assets.
> **Statement 3:** The depreciation index (DEPI) value was slightly greater than 1, indicating the current period's depreciation rate was greater than the prior period's depreciation rate.

After further analysis, Cho concludes that in the absence of potential earnings manipulation, Philbin would generate sustainable earnings.

i.
In Cho's three statements, she referenced three indexes used in the model. Of these three, the index that is *most likely* to be useful in determining whether the firm is potentially manipulating earnings by capitalizing operating expenses is the:

- ○ Sales growth index.
- ◉ Asset quality index.
- ○ Depreciation index.

Rationale
This Answer is Correct
The asset quality index (AQI) measures the increase in capitalized expenditures not classified as PP&E or CA. These additional capitalized expenditures are potentially operating expenditures that have been capitalized to reduce operating expenses and inflate operating income.

Rationale
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Rationale

This Answer is Correct

The asset quality index (AQI) measures the increase in capitalized expenditures not classified as PP&E or CA. These additional capitalized expenditures are potentially operating expenditures that have been capitalized to reduce operating expenses and inflate operating income.

ii.

Which of Cho's statements to Markowitz is *most likely* incorrect?

- ( ) Statement 1.
- ( ) Statement 2.
- (•) Statement 3.

Rationale

This Answer is Incorrect

A positive value on the depreciation index (DEPI) increases the likelihood of earnings manipulation reflected in a higher Mscore. The DEPI is calculated as follows:

$$\text{DEPI} = \frac{\text{Depreciation rate}_{t-1}}{\text{Depreciation rate}_t}, \text{ where Depreciation rate} = \frac{\text{Depreciation}}{(\text{Depreciation} + \text{PPE})}$$

Given the formula above, the depreciation rate in the prior period must be higher than the depreciation rate in the current period in order for this index to be greater than 1.0. But her statement is that the current period's depreciation rate was greater than the prior period's depreciation rate. If the current rate is higher than the prior period rate, the index value would be less than 1.0.

Rationale

This Answer is Incorrect

A positive value on the depreciation index (DEPI) increases the likelihood of earnings manipulation reflected in a higher Mscore. The DEPI is calculated as follows:

$$\text{DEPI} = \frac{\text{Depreciation rate}_{t-1}}{\text{Depreciation rate}_t}, \text{ where Depreciation rate} = \frac{\text{Depreciation}}{(\text{Depreciation} + \text{PPE})}$$

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Rationale

This Answer is Incorrect

A positive value on the depreciation index (DEPI) increases the likelihood of earnings manipulation reflected in a higher Mscore. The DEPI is calculated as follows:

$$\text{DEPI} = \frac{\text{Depreciation rate}_{t-1}}{\text{Depreciation rate}_t}, \text{where Depreciation rate} = \frac{\text{Depreciation}}{(\text{Depreciation} + \text{PPE})}$$

Given the formula above, the depreciation rate in the prior period must be higher than the depreciation rate in the current period in order for this index to be greater than 1.0. But her statement is that the current period's depreciation rate was greater than the prior period's depreciation rate. If the current rate is higher than the prior period rate, the index value would be less than 1.0.

iii.

Based on the calculated *M*-score, the analyst will *most likely* conclude that Philbin Corp.'s quality of financial results is:

- low.
- high.
- moderate.

Rationale

This Answer is Incorrect

The intercept term in the formula is –4.84 and the quality of the financial results fall as the *M*-score moves toward zero or even a positive number. Beneish recommended a –1.78 threshold for earnings manipulation with less negative or positive *M*-scores representing a higher risk of earnings manipulation—a sign of low quality financial results. Given that Philbin's –3.78 *M*-score, it is likely that Cho will conclude the quality of financial results is high.

Rationale

This Answer is Incorrect

The intercept term in the formula is –4.84 and the quality of the financial results fall as the *M*-score moves toward zero or even a positive number. Beneish recommended a –1.78 threshold for earnings manipulation with less negative or positive *M*-scores representing a higher risk of earnings manipulation—a sign of low quality financial results. Given that Philbin's –3.78 *M*-score, it is likely that Cho will conclude the quality of financial results is high.

Rationale

This Answer is Incorrect

The intercept term in the formula is –4.84 and the quality of the financial results fall as the *M*-score moves toward zero or even a positive number. Beneish recommended a –1.78 threshold for earnings manipulation with less negative or positive *M*-scores representing a higher risk of earnings manipulation—a sign of low quality financial results. Given that Philbin's –3.78 *M*-score, it is likely that Cho will conclude the quality of financial results is high.

Question 5
L2R21TB-AC023-1512
LOS: LOS-7160
Lesson Reference: Lesson 2: Evaluating the Quality of Financial Reports
Difficulty: medium
Allen Corp. has acquired several companies per year over the last few years. After each acquisition, Allen records large restructuring charges. Regarding these restructuring charges, an analyst's *best* course of action is to:

- Back out the restructuring charge in the current period.
- Spread the charge over current and applicable prior periods.
- Leave in the restructuring charge under the assumption it will “smooth out” over the long term.

Rationale

Back out the restructuring charge in the current period.
Each restructuring charge should be spread over the current and applicable prior periods for comparison purposes. Backing out the charge leaves previous periods impaired by the structure that was being changed, and will not provide a good basis for forecasting future earnings and cash flow growth. Smoothing out is unlikely unless acquisitions are exactly the same size each time.

Rationale

Spread the charge over current and applicable prior periods.
Each restructuring charge should be spread over the current and applicable prior periods for comparison purposes. Backing out the charge leaves previous periods impaired by the structure that was being changed, and will not provide a good basis for forecasting future earnings and cash flow growth. Smoothing out is unlikely unless acquisitions are exactly the same size each time.

Rationale

Leave in the restructuring charge under the assumption it will “smooth out” over the long term.
Each restructuring charge should be spread over the current and applicable prior periods for comparison purposes. Backing out the charge leaves previous periods impaired by the structure that was being changed, and will not provide a good basis for forecasting future earnings and cash flow growth. Smoothing out is unlikely unless acquisitions are exactly the same size each time.

Question 6
L2FR-PQ2001-1501
LOS: LOS-7140
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: hard

Consider the following statements:

Statement 1: Aggressive accounting choices are more likely than conservative accounting choices to give rise to a sustainability issue.

Statement 2: Financial reporting quality is a prerequisite for assessing earnings quality.

Which of the following is *most* likely?

- ○ Only Statement 1 is correct.
- ○ Only Statement 2 is correct.
- ● Both statements are correct.

Rationale

This Answer is Correct

Aggressive accounting choices in the current period can lead to depressed performance in future periods, giving rise to a sustainability issue. Conservative choices in the current period lead to improved performance going forward. Therefore, they do not result in a sustainability issue.

Earnings quality cannot be evaluated until there is some assurance regarding the quality of financial reporting.

Question 7
L2R21TB-AC017-1512
LOS: LOS-7160
Lesson Reference: Lesson 2: Evaluating the Quality of Financial Reports
Difficulty: medium
Filmore Corp. is known by analysts to engage in conservative accounting choices. The *most likely* result of this practice is:

- ○ Higher equity.
- ○ Increased assets.
- ◉ Better future results.

Rationale
✖ Higher equity.
Conservative accounting choices decrease current reported performance and will likely lead to more impressive future results. With current reported performance (earnings) being lower, equity is understated. With equity being understated, the offset has to the either understated assets or overstated liabilities.

Rationale
✖ Increased assets.
Conservative accounting choices decrease current reported performance and will likely lead to more impressive future results. With current reported performance (earnings) being lower, equity is understated. With equity being understated, the offset has to the either understated assets or overstated liabilities.

Rationale
✔ Better future results.
Conservative accounting choices decrease current reported performance and will likely lead to more impressive future results. With current reported performance (earnings) being lower, equity is understated. With equity being understated, the offset has to the either understated assets or overstated liabilities.

Question 8

L2R21TB-AC019-1512

LOS: LOS-7180

Lesson Reference: Lesson 3: Earnings Quality

Difficulty: medium

Alpha Medical Software Corp. recently classified sales of its billing software to Medical Centre Hospital as support revenues. Alpha's *most likely* reason for doing so is to:

- Use conservative accounting.
- Match the ongoing update costs.
- Increase its common share valuation.

Rationale

Use conservative accounting.

Firms are valued more highly when revenue appears sustainable and less volatile. Thus, reclassifying from software sales (non-sustainable and highly variable) to support revenue will give the appearance of sustainable, less variable revenues leading analysts to assign a higher valuation to the company's shares in the short term.

Rationale

Match the ongoing update costs.

Firms are valued more highly when revenue appears sustainable and less volatile. Thus, reclassifying from software sales (non-sustainable and highly variable) to support revenue will give the appearance of sustainable, less variable revenues leading analysts to assign a higher valuation to the company's shares in the short term.

Rationale

Increase its common share valuation.

Firms are valued more highly when revenue appears sustainable and less volatile. Thus, reclassifying from software sales (non-sustainable and highly variable) to support revenue will give the appearance of sustainable, less variable revenues leading analysts to assign a higher valuation to the company's shares in the short term.

Question 9

L2FR-PQ2012-1501

LOS: LOS-7210

Lesson Reference: Lesson 3: Earnings Quality

Difficulty: hard

Under the Altman model, a higher *Z*-score *most* likely indicates:

- (selected) A lower probability of default.
- A higher probability of default.
- A higher probability of earnings manipulation.

Rationale

This Answer is Correct

A higher *Z*-score is more desirable, as it suggests a lower chance of bankruptcy.

Question 10

L2R21TB-AC020-1512

LOS: LOS-7150

Lesson Reference: Lesson 1: Quality of Financial Reports

Difficulty: medium

An analyst for a wealth management firm recently noticed that operating margins for Petrof Corp. had increased substantially in the current period although current sales exhibited no growth over the prior period's sales. The analyst called the company to inquire whether there had been any change in operations that could account for the change in margins, but was told that the sales staff had become more efficient. Petrof Corp. *most likely* accomplished the improved operating margin by:

- Channel stuffing.
- Inconsistent operating revenue classification.
- Classifying operating expenses as non-operating.

Rationale

Channel stuffing.

Manipulation of expenses would be the most likely cause of the margin improvement, because revenues have remained the same.

Rationale

Inconsistent operating revenue classification.

Manipulation of expenses would be the most likely cause of the margin improvement, because revenues have remained the same.

Rationale

Classifying operating expenses as non-operating.

Manipulation of expenses would be the most likely cause of the margin improvement, because revenues have remained the same.

Question 11
L2R21TB-AC016-1512
LOS: LOS-7220
Lesson Reference: Lesson 4: Cash Flow Quality
Difficulty: medium
A firm attempting to make operating cash flows appear stronger than what economic reality would support will *most likely* try to accelerate:

- ○ Payables by taking advantage of discounts for early payment.
- ◉ Receivables by offering bigger discounts for early payment.
- ○ The timing of the purchase of land for a new plant.

Rationale
✖ **Payables by taking advantage of discounts for early payment.**
Accelerating receivables involves collecting the receivables sooner, and this will allow operating cash flow to appear stronger. Accelerating payables entails paying sooner, which will reduce, not improve cash flows. Buying land sooner will have no effect on operating cash flows, as the expenditure is an investing outflow.

Rationale
✔ **Receivables by offering bigger discounts for early payment.**
Accelerating receivables involves collecting the receivables sooner, and this will allow operating cash flow to appear stronger. Accelerating payables entails paying sooner, which will reduce, not improve cash flows. Buying land sooner will have no effect on operating cash flows, as the expenditure is an investing outflow.

Rationale
✖ **The timing of the purchase of land for a new plant.**
Accelerating receivables involves collecting the receivables sooner, and this will allow operating cash flow to appear stronger. Accelerating payables entails paying sooner, which will reduce, not improve cash flows. Buying land sooner will have no effect on operating cash flows, as the expenditure is an investing outflow.

Question 12
L2FR-PQ2002-1501
LOS: LOS-7140
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: hard
A company defers certain R&D expenditures until the next accounting period in order to improve reported performance for the current year. This is *most* likely an example of managing earnings via:

- (selected) Real actions.
- Accounting choices.
- Fictitious transactions.

Rationale

This Answer is Correct

This is an example of managing earnings by taking real actions.

Question 13
L2FR-TB0030-1412
LOS: LOS-7160
Lesson Reference: Lesson 2: Evaluating the Quality of Financial Reports
Difficulty: medium
An analyst using the Beneish Model as a quantitative tool to assess the likelihood of misreporting will *most likely* find that:

- ○ A decrease in receivables as a percentage of sales will result in a higher M-score.
- ○ An increase in gross margins will lead to a lower M-score.
- ◉ An increase in sales will lead to a higher M-score.

Rationale

This Answer is Correct

The Beneish model calculates an M-score, which represents the probability of manipulation of financial reports. An increase in accounts receivable as a percentage of sales could indicate inappropriate revenue recognition and will increase the M-score. Deterioration in gross margins could predispose companies to manipulate earnings and increases the M-score. Increasing sales could lead the company to manage the perception of continuing growth and predispose management to manipulate sales and earnings, thus increasing the M-score.

Question 14
L2R21TB-AC013-1512
LOS: LOS-7210
Lesson Reference: Lesson 3: Earnings Quality
Difficulty: medium
A competitor sued Davidson-Lowry, Inc. (DLI) to stop it from using a manufacturing process that the competitor claims was stolen. A judge ruled that DLI can continue to use this process for the next two years. This process is critical to DLI's manufacturing of its one product. Davidson-Lowry, Inc. described the outcome of the suit in a decision-useful way, and in all other ways complied with accounting standards in its reporting and disclosures. Davidson- Lowry's quality of financial results (earnings) could *best* be described as:

- (selected) Low.
- High.
- Extremely high.

Rationale
✓ **Low.**
The reporting quality is high, but the financial results (earnings) quality is low. Unfortunately, DLI's core manufacturing process will be unusable in two years, and this makes it highly likely that the earnings are unsustainable. Thus, the earnings quality is low.

Rationale
✗ **High.**
The reporting quality is high, but the financial results (earnings) quality is low. Unfortunately, DLI's core manufacturing process will be unusable in two years, and this makes it highly likely that the earnings are unsustainable. Thus, the earnings quality is low.

Rationale
✗ **Extremely high.**
The reporting quality is high, but the financial results (earnings) quality is low. Unfortunately, DLI's core manufacturing process will be unusable in two years, and this makes it highly likely that the earnings are unsustainable. Thus, the earnings quality is low.

Question 15
L2FR-TBB205-1412
LOS: LOS-7180
Lesson Reference: Lesson 3: Earnings Quality
Difficulty: medium
A company with unstable pro forma earnings versus stable earnings under generally accepted accounting principles (GAAP) *most likely* has:

- ○ High persistency in earnings.
- ◉ High nonrecurring items.
- ○ High-quality earnings.

Rationale

This Answer is Correct

Pro forma accounts are non-GAAP earnings reported by companies in order to exclude the impact of nonrecurring items. A company with stable earnings, but unstable pro forma earnings is likely to have high nonrecurring items, and hence lower quality earnings.

Question 16
L2R21TB-AC008-1512
LOS: LOS-7150
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: medium
A company's CFO created fictitious employees and cashed their paychecks with the help of a bank employee. The CFO's actions *most likely* resulted in:

- ○ Understated expenses and overstated liabilities.
- ○ Overstated equity and understated liabilities.
- ◉ Understated equity and understated assets.

Rationale
✖ **Understated expenses and overstated liabilities.**
The CFO's actions have resulted in overstated expenses for wages. This will cause equity to be understated, as net income is understated. The most likely offset on the balance sheet is understated assets in the form of lower cash. It is also possible that liabilities could be overstated as of a reporting date if wage expense has been accrued but not yet paid.

Rationale
✖ **Overstated equity and understated liabilities.**
The CFO's actions have resulted in overstated expenses for wages. This will cause equity to be understated, as net income is understated. The most likely offset on the balance sheet is understated assets in the form of lower cash. It is also possible that liabilities could be overstated as of a reporting date if wage expense has been accrued but not yet paid.

Rationale
✔ **Understated equity and understated assets.**
The CFO's actions have resulted in overstated expenses for wages. This will cause equity to be understated, as net income is understated. The most likely offset on the balance sheet is understated assets in the form of lower cash. It is also possible that liabilities could be overstated as of a reporting date if wage expense has been accrued but not yet paid.

Question 17

L2FR-TBX111-1502

LOS: LOS-7200

Lesson Reference: Lesson 3: Earnings Quality

Difficulty: easy

A company with low-quality earnings is *most likely* to exhibit:

- Low accruals.
- High discretionary accruals.
- High nondiscretionary accruals.

Rationale

This Answer is Correct

Earnings with a larger component of accruals are typically less persistent and of lower quality. An important distinction is between accruals that arise from normal transactions in the period (called nondiscretionary) and accruals that result from transactions or accounting choices outside the normal (called discretionary accruals). The discretionary accruals are possibly made with the intent to distort earnings.

Question 18
L2R21TB-AC022-1512
LOS: LOS-7150
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: medium
Devour Corp. has announced the planned acquisition of a competitor, with the deal to close in 90 days, which falls immediately after Devour will report its annual results. Devour's president wishes to make sure that market participants view the acquisition as having been successful in the upcoming post-acquisition year. Without having any economic rationale for doing so, the president will *most likely* have the company's accountants immediately:

- (selected) Write-down inventories.
- Decrease the payments made on accounts payable.
- Increase the estimated useful lives on plant and equipment owned.

Rationale
✔ **Write-down inventories.**
The unwarranted write-down of inventories will reduce the current year's earnings. With lower current earnings, it will be easier to make the acquisition appear successful.

Rationale
✖ **Decrease the payments made on accounts payable.**
The unwarranted write-down of inventories will reduce the current year's earnings. With lower current earnings, it will be easier to make the acquisition appear successful.

Rationale
✖ **Increase the estimated useful lives on plant and equipment owned.**
The unwarranted write-down of inventories will reduce the current year's earnings. With lower current earnings, it will be easier to make the acquisition appear successful.

Question 19

L2R21TB-AC027-1512

LOS: LOS-7170

Lesson Reference: Lesson 2: Evaluating the Quality of Financial Reports

Difficulty: medium

An analyst uses the Beneish model to find the M-score, which is then used to determine the probability that a firm is engaging in earnings management. A firm being investigated has seen its total assets grow from €3.2 billion to €3.8 billion, with current assets rising from €0.6 billion to €0.9 billion, and property, plant, and equipment (PP&E) dropping from €2.4 billion to €2.1 billion. For the current year, the analyst will *most likely* conclude that the asset quality index input in the Beniesh model caused the probability of earnings management to be:

- Lower because the PP&E is being used more efficiently.
- Lower because a higher percentage of the assets are current.
- Higher because assets other than current assets and PP&E rose as a percentage of the total assets in the current year.

Rationale

Lower because the PP&E is being used more efficiently.

The asset quality index measures the percentage of assets that were not property, plant and equipment or current assets. This measure can help analysts determine the probability of earnings management by capitalizing expenses (recording them as other assets) that should be taken to profit and loss in the current period. The total assets increased €0.6 billion in the current year, but the combined current assets and PP&E did not change from €3.0 billion. Therefore, other assets rose as a percentage of total assets and this will increase the M-score toward zero or above, which indicates a higher likelihood of earnings manipulation.

Rationale

Lower because a higher percentage of the assets are current.

The asset quality index measures the percentage of assets that were not property, plant and equipment or current assets. This measure can help analysts determine the probability of earnings management by capitalizing expenses (recording them as other assets) that should be taken to profit and loss in the current period. The total assets increased €0.6 billion in the current year, but the combined current assets and PP&E did not change from €3.0 billion. Therefore, other assets rose as a percentage of total assets and this will increase the M-score toward zero or above, which indicates a higher likelihood of earnings manipulation.

Rationale

Higher because assets other than current assets and PP&E rose as a percentage of the total assets in the current year.

The asset quality index measures the percentage of assets that were not property, plant and equipment or current assets. This measure can help analysts determine the probability of earnings management by capitalizing expenses (recording them as other assets) that should be taken to profit and loss in the current period. The total assets increased €0.6 billion in the current year, but the combined current assets and PP&E did not change from €3.0 billion. Therefore, other assets rose as a percentage of total assets and this will increase the M-score toward zero or above, which indicates a higher likelihood of earnings manipulation.

Question 20
L2R21TB-AC021-1512
LOS: LOS-7150
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: medium
If an acquiring company pays for the target by issuing equity, the cash flow statement will *most likely* reflect the share issuance and value of acquired assets:

- (selected) Nowhere.
- In the equity section.
- In the investing section.

Rationale
✔ **Nowhere.**
The transaction involved no cash, and will, therefore, be reflected on the balance sheet but not the cash flow statement.

Rationale
✖ **In the equity section.**
The transaction involved no cash, and will, therefore, be reflected on the balance sheet but not the cash flow statement.

Rationale
✖ **In the investing section.**
The transaction involved no cash, and will, therefore, be reflected on the balance sheet but not the cash flow statement.

Question 21
L2R21TB-AC025-1512
LOS: LOS-7260
Lesson Reference: Lesson 6: Sources of Information about Risk
Difficulty: medium
Megaliner manufactures aircraft for transcontinental flights. Megaliner's backlog would *most likely* be reflected in the:

- ○ Assets on the balance sheet.
- ○ Footnotes to revenue on the income statement.
- ◉ Management's discussion and analysis of results.

Rationale
This Answer is Correct
Most GAAP do not recognize backlog as an asset until revenues have been recorded. Thus, the backlog is unlikely to appear on the financial statements, but it is likely to be discussed in management's discussion and analysis of results.

Question 22

L2FR-PQ2007-1501

LOS: LOS-7150

Lesson Reference: Lesson 1: Quality of Financial Reports

Difficulty: hard

Understated interest payable will *most* likely result in:

- Overstated income and understated liabilities.
- Understated income and understated liabilities.
- Overstated assets and liabilities.

Rationale

This Answer is Correct

Understated interest, taxes, or other expenses result in understated related liabilities (accrued interest payable, taxes payable, or other payables). They also result in understated expenses, overstated income, and overstated equity.

Question 23

L2FR-PQ2006-1501

LOS: LOS-7150

Lesson Reference: Lesson 1: Quality of Financial Reports

Difficulty: hard

Which of the following is *most* likely if a company records fictitious revenue?

- (selected) Overstated income, overstated equity, and overstated assets.
- Overstated income, overstated equity, and understated liabilities.
- Understated income, understated equity, and understated assets.

Rationale

This Answer is Correct

Aggressive, premature, and fictitious revenue recognition results in overstated income and, consequently, overstated equity. Further, assets (typically accounts receivable) are also overstated.

Question 24
L2FR-PQ2011-1501
LOS: LOS-7180
LOS: LOS-7190
LOS: LOS-7200
Lesson Reference: Lesson 3: Earnings Quality
Difficulty: hard

Consider the following statements:

Statement 1: The larger the accruals component of earnings, the higher the quality of earnings, and the slower the expected mean reversion in earnings.

Statement 2: If a company's CFO grows in line with net income, it precludes the possibility of earnings manipulation.

Which of the following is *most* likely?

- Only Statement 1 is correct.
- Only Statement 2 is correct.
- Both statements are incorrect.

Rationale
This Answer is Correct

The larger the accruals component of earnings, the lower the level of persistence and, therefore, the lower the quality of earnings. Further, the lower the level of persistence, the quicker the expected mean reversion in earnings.

Note that although significant accruals can suggest earnings manipulation, it is not necessary for all fraudulent companies to have sizeable accruals. WorldCom Inc., for example, improperly capitalized certain operating costs instead of expensing them, thereby classifying related cash outflows as investing outflows (instead of as operating cash outflows). Therefore, it was able to report cash flow from operating activities in excess of net income.

Question 25
L2FR-PQ2008-1501
LOS: LOS-7150
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: hard
Understatement of contingent liabilities *least* likely results in:

- ○ Overstated other comprehensive income.
- ○ Overstated equity.
- ● Overstated expenses.

Rationale

This Answer is Correct

Understatement of contingent liabilities comes with overstated equity resulting from understated expenses and overstated income or overstated other comprehensive income.

Question 26
L2R21TB-AC012-1512
LOS: LOS-7140
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: medium
Adeline Corp. recently released financial information. Current earnings in both accrual and cash terms were sufficient to meet current and near-term future operational needs. However, one line of business had come under increased pressure from competition such that margins may decrease in the future. Management's discussion of results presented only a generic description of how potential competition could erode future earnings. Adeline's quality of financial results could *best* be described as:

- Low.
- High.
- Only moderately high.

Rationale
Low.
Management's discussion of results should have included information regarding specific threats from competition to Adeline's business unit. An analyst should closely watch earnings sustainability, although sufficient and sustainable at this point, for signs of further competitive threats. In the conceptual framework, reporting would be moderately useful for decisions, while its earnings quality is moderately high because the earnings are sufficient to meet current and near-term future operational needs, but may not be sustainable due to competitive threats.

Rationale
High.
Management's discussion of results should have included information regarding specific threats from competition to Adeline's business unit. An analyst should closely watch earnings sustainability, although sufficient and sustainable at this point, for signs of further competitive threats. In the conceptual framework, reporting would be moderately useful for decisions, while its earnings quality is moderately high because the earnings are sufficient to meet current and near-term future operational needs, but may not be sustainable due to competitive threats.

Rationale
Only moderately high.
Management's discussion of results should have included information regarding specific threats from competition to Adeline's business unit. An analyst should closely watch earnings sustainability, although sufficient and sustainable at this point, for signs of further competitive threats. In the conceptual framework, reporting would be moderately useful for decisions, while its earnings quality is moderately high because the earnings are sufficient to meet current and near-term future operational needs, but may not be sustainable due to competitive threats.

Question 27
L2R21TB-AC015-1512
LOS: LOS-7160
Lesson Reference: Lesson 2: Evaluating the Quality of Financial Reports
Difficulty: medium
Understated contingent liabilities will *most likely* result in:

- ○ Understated income.
- ○ Overstated expenses.
- ● Overstated owners' equity.

Rationale

✗ Understated income.
Contingent liabilities reflect uncertain future expenses. Failing to record such a liability understates expenses (e.g., the negative outcome of a lawsuit), and consequently overstates current income. Overstating current income results in overstated owners' equity.

Rationale

✗ Overstated expenses.
Contingent liabilities reflect uncertain future expenses. Failing to record such a liability understates expenses (e.g., the negative outcome of a lawsuit), and consequently overstates current income. Overstating current income results in overstated owners' equity.

Rationale

✓ Overstated owners' equity.
Contingent liabilities reflect uncertain future expenses. Failing to record such a liability understates expenses (e.g., the negative outcome of a lawsuit), and consequently overstates current income. Overstating current income results in overstated owners' equity.

Question 28
L2FR-PQ2010-1501
LOS: LOS-7160
LOS: LOS-7170
Lesson Reference: Lesson 2: Evaluating the Quality of Financial Reports
Difficulty: hard
Under the Beneish model, a higher *M*-score *most* likely indicates that:

- ○ There is a low probability of earnings manipulation.
- ◉ There is a high probability of earnings manipulation.
- ○ There is a high probability of default.

Rationale

This Answer is Correct

The higher the *M*-score (i.e., the less negative the number), the higher the probability of earnings manipulation.

Question 29
L2R21TB-ITEMSET-AC004-1512
LOS: LOS-7150
LOS: LOS-7160
LOS: LOS-7170
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: medium

Use the following information to answer the next three questions:

Alonso Marr is examining the financial statements, notes to financial statements, and management discussion and analysis (MD&A) for Rodriguez Manufacturing Company in preparation for a meeting with Alicia Morningstar, the director of research at his firm. Marr has uncovered a variety of interesting items regarding Rodriguez Manufacturing and looks forward to discussing these with Morningstar.

During his meeting with Morningstar, Marr makes the following observations:

Observation 1:

Goodwill for Rodriguez Manufacturing was determined to be impaired and a charge was taken to write it down in the current period. The Company determined it was overstated based on the viability of technology acquired two years ago when Rodriguez Manufacturing purchased Safeline, Inc. The technology acquired was surpassed by newer and better technology in the prior year, but Rodriguez Manufacturing's management waited over a year before recognizing this fact.

Observation 2:

Midway through the current year, Rodriguez Manufacturing discontinued the manufacture of solar cells when it was determined that the costs of remediating contaminated water and other hazardous waste associated with solar manufacturing could be astronomical if the government starts requiring remediation as expected. During the years that it made solar panels, Rodriguez Manufacturing stored the contaminated waste at a tank farm on its property. The Company recorded a non-operating charge in order to account for these costs, with the offsetting accounting entry being an accrued liability.

Observation 3:

Rodriguez Manufacturing has complied with GAAP for reporting purposes, but has left some doubt about whether management has used unbiased estimates for various discretionary components. The input values for calculating pension expense have been changed slightly each year for the last three years. Based on the information used by management, however, the reported earnings would appear sustainable.

i.
The goodwill impairment in the current year results in Marr *most likely* questioning the quality of Rodriguez Manufacturing's financial reports because:

- (selected) Assets were likely overstated in the prior year.
- Amortization expense was likely understated in the prior year.
- Amortization expense will now be understated in future years.

Rationale

This Answer is Correct

It appears that Rodriguez Manufacturing overstated the value of goodwill in the prior period, as it should have been written down for the impairment when the new technology was introduced. Goodwill is not amortized, so there is no misstatement of amortization expense in prior or future periods.

Rationale

This Answer is Correct

It appears that Rodriguez Manufacturing overstated the value of goodwill in the prior period, as it should have been written down for the impairment when the new technology was introduced. Goodwill is not amortized, so there is no misstatement of amortization expense in prior or future periods.

Rationale

This Answer is Correct

It appears that Rodriguez Manufacturing overstated the value of goodwill in the prior period, as it should have been written down for the impairment when the new technology was introduced. Goodwill is not amortized, so there is no misstatement of amortization expense in prior or future periods.

ii.

Marr, in an effort to complete a comparison of the current period's earnings to prior period's earnings, will *most likely*:

- Reclassify the entire non-operating charge as being an operating expense in the current year only.
- Only remove the non-operating charge from current period reported results, as the cash cost will be incurred in future years.
- Remove the non-operating charge from the current period reported results and spread this charge over the years, including the current year, that the Company manufactured solar panels, with it being treated as an operating expense each year.

Rationale

This Answer is Incorrect

To adjust the current and prior periods' financial statements to reflect economic reality, Marr should treat the non-operating charge as being operating because it is a cost to manufacturing solar panels and spread this cost over the years in which the Company made solar panels.

Rationale

This Answer is Incorrect

To adjust the current and prior periods' financial statements to reflect economic reality, Marr should treat the non-operating charge as being operating because it is a cost to manufacturing solar panels and spread this cost over the years in which the Company made solar panels.

Rationale

This Answer is Incorrect

To adjust the current and prior periods' financial statements to reflect economic reality, Marr should treat the non-operating charge as being operating because it is a cost to manufacturing solar panels and spread this cost over the years in which the Company made solar panels.

iii.

Based only on the information in Observation 3, Rodriguez Manufacturing's quality of financial results could *best* be characterized as:

- High quality because they are GAAP compliant.
- High quality because the net pension asset is understated.
- Low quality if Marr decides the changes are being made to meet earnings targets.

Rationale

This Answer is Incorrect

The reporting is GAAP compliant, but management's changes with respect to the pension inputs could be a warning sign of earnings management. If the changes are being made to manage earnings, then the financial results quality is low. Given the information provided, there is no way to know whether the pension asset, assuming they even have a pension asset and not a liability, is understated.

Rationale

This Answer is Incorrect

The reporting is GAAP compliant, but management's changes with respect to the pension inputs could be a warning sign of earnings management. If the changes are being made to manage earnings, then the financial results quality is low. Given the information provided, there is no way to know whether the pension asset, assuming they even have a pension asset and not a liability, is understated.

Rationale

This Answer is Incorrect

The reporting is GAAP compliant, but management's changes with respect to the pension inputs could be a warning sign of earnings management. If the changes are being made to manage earnings, then the financial results quality is low. Given the information provided, there is no way to know whether the pension asset, assuming they even have a pension asset and not a liability, is understated.

Question 30
L2R21TB-AC026-1512
LOS: LOS-7210
Lesson Reference: Lesson 3: Earnings Quality
Difficulty: medium
An analyst estimating earnings for Tringale Corp. noticed in the pension footnote that the company had decreased its salary trend rate estimate. The analyst believes this change was not justified. In order to compare this current period with prior period earnings, the analyst would *most likely* adjust the current period by:

- ○ Increasing earnings.
- ◉ Decreasing earnings.
- ○ Increasing the net pension asset.

Rationale

✗ Increasing earnings.
Decreasing the salary trend rate reduces the service cost component of pension expense. With lower service cost in the pension expense in the current year as compared to the prior period, the current period's pension expense is understated. To adjust to make the two years more comparable, the analyst should increase the current year's pension expense, which then reduces net income.

Rationale

✓ Decreasing earnings.
Decreasing the salary trend rate reduces the service cost component of pension expense. With lower service cost in the pension expense in the current year as compared to the prior period, the current period's pension expense is understated. To adjust to make the two years more comparable, the analyst should increase the current year's pension expense, which then reduces net income.

Rationale

✗ Increasing the net pension asset.
Decreasing the salary trend rate reduces the service cost component of pension expense. With lower service cost in the pension expense in the current year as compared to the prior period, the current period's pension expense is understated. To adjust to make the two years more comparable, the analyst should increase the current year's pension expense, which then reduces net income.

Question 31
L2R21TB-AC007-1512
LOS: LOS-7140
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: medium
Rocco Salvatore was CFO of a company until he resigned in the current accounting period. In his letter of resignation, Salvatore described an environment in which the CEO constantly threatened that Salvatore would be fired if he failed to find ways to show better results for the firm. Salvatore admitted to allowing sales reps to provide kickbacks to customers in order to encourage more sales, and disguising them as payments to suppliers. Although the company had sufficient actual earnings for an adequate, sustainable return to capital, he admitted to booking fictitious revenue sufficient for the CEO to receive his bonuses. This firm's reporting and results could *best* be characterized as:

- ○ Low earnings quality and low reporting quality.
- ◉ High earnings quality and low reporting quality.
- ○ High earnings quality and moderate reporting quality.

Rationale

✖ **Low earnings quality and low reporting quality.**

Reporting quality is low because of the fictitious information in the financial reports. Earnings quality is actually high because the firm's earnings without the fictitious revenue are sufficient to cover its cost of capital and appear sustainable. Those good results, however, are likely to go unrewarded once low reporting quality is suspected and investors conclude that the reported earnings are of little use.

Rationale

✔ **High earnings quality and low reporting quality.**

Reporting quality is low because of the fictitious information in the financial reports. Earnings quality is actually high because the firm's earnings without the fictitious revenue are sufficient to cover its cost of capital and appear sustainable. Those good results, however, are likely to go unrewarded once low reporting quality is suspected and investors conclude that the reported earnings are of little use.

Rationale

✖ **High earnings quality and moderate reporting quality.**

Reporting quality is low because of the fictitious information in the financial reports. Earnings quality is actually high because the firm's earnings without the fictitious revenue are sufficient to cover its cost of capital and appear sustainable. Those good results, however, are likely to go unrewarded once low reporting quality is suspected and investors conclude that the reported earnings are of little use.

Question 32
L2R21TB-AC009-1512
LOS: LOS-7170
Lesson Reference: Lesson 2: Evaluating the Quality of Financial Reports
Difficulty: medium
The Beneish model is used to compare two firms, with firm A having an M-score of –0.23 and firm B having an M-score of –3.28. In assessing these two companies based only on their M-scores, an analyst will *most likely* conclude that:

- (selected) Firm A has a higher percentage probability of reporting manipulation.
- Firm B has a higher percentage probability of reporting manipulation.
- Neither firm has a high percentage probability of reporting manipulation because both M-scores are less than zero (0).

Rationale
✔ **Firm A has a higher percentage probability of reporting manipulation.**
As the M-score increases toward and above 0, the probability of manipulation increases. Since firm A's M-score is significantly larger (closer to zero), it has a higher percentage probability of reporting manipulation.

Rationale
✘ **Firm B has a higher percentage probability of reporting manipulation.**
As the M-score increases toward and above 0, the probability of manipulation increases. Since firm A's M-score is significantly larger (closer to zero), it has a higher percentage probability of reporting manipulation.

Rationale
✘ **Neither firm has a high percentage probability of reporting manipulation because both M-scores are less than zero (0).**
As the M-score increases toward and above 0, the probability of manipulation increases. Since firm A's M-score is significantly larger (closer to zero), it has a higher percentage probability of reporting manipulation.

Question 33
L2FR-TB0027-1412
LOS: LOS-7140
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: medium
Which of the following statements regarding the quality of financial reports and earning is *least accurate?*

- ○ Low financial reporting quality always impedes valuation.
- ◉ Valuation can only be carried out on companies with high financial reporting quality and high earnings quality.
- ○ In order to have a high valuation, a company must have high-quality financial reporting and high-quality earnings.

Rationale

This Answer is Correct

Answer B is incorrect since valuation can be carried out on companies with high reporting quality and low earnings quality. Answers A and C are correct.

Question 34
L2R21TB-AC011-1512
LOS: LOS-7250
Lesson Reference: Lesson 5: Balance Sheet Quality
Difficulty: medium
Genesee Corp. has 1 million shares of stock outstanding with a current market price per share of $14. The Company has $20 million in assets, including $15 million in goodwill, and no liabilities. An analyst will *most likely* conclude that Genesee's balance sheet is not reflecting the attribute of:

- ○ Completeness.
- ◉ Unbiased basis.
- ○ Clear presentation.

Rationale

This Answer is Correct

The recorded goodwill at $15 million is in excess of the $14 million market value for the shares. Investors are either applying a negative value to the $5 million in non-goodwill assets or, more likely, investors believe the goodwill is not worth its $15 million carrying value. This would indicate a lack of unbiased basis attribute.

Question 35
L2FR-TBX112-1502
LOS: LOS-7220
Lesson Reference: Lesson 4: Cash Flow Quality
Difficulty: easy
Which of the following scenarios is *most likely* to be evidence of low-quality reporting on the cash flow statement?

- ○ Falling days' sales outstanding.
- ○ Allowance for doubtful debts growing slower than sales.
- ● Large unusual gains added back to net income in an indirect reconciliation of net income with cash flow from operations.

Rationale

This Answer is Correct

Falling days' sales outstanding and allowance for doubtful debts growing slower than sales suggests that the company is collecting its receivables faster and that creditworthiness of customers is increasing—both good signs for cash flows. An unusual gain in the income statement should be subtracted from net income when reconciling to operating cash flow under the indirect method, not added back.

Question 36

L2R21TB-AC029-1512

LOS: LOS-7180

Lesson Reference: Lesson 3: Earnings Quality

Difficulty: medium

A firm classified an ordinary expense as non-recurring. This change in classification will *most likely* increase the:

- ○ Reported net profit.
- ○ Reported operating cash flow.
- ● The profit that initially appears sustainable.

Rationale

Reported net profit.

The choice made just moves the expense further down the income statement, but does not change the net income (profit). The goal in making the change is to inflate the amount of income that appears sustainable. This occurs if analysts do not realize what has occurred and if they ignore non-recurring expenses when finding sustainable income.

Rationale

Reported operating cash flow.

The choice made just moves the expense further down the income statement, but does not change the net income (profit). The goal in making the change is to inflate the amount of income that appears sustainable. This occurs if analysts do not realize what has occurred and if they ignore non-recurring expenses when finding sustainable income.

Rationale

The profit that initially appears sustainable.

The choice made just moves the expense further down the income statement, but does not change the net income (profit). The goal in making the change is to inflate the amount of income that appears sustainable. This occurs if analysts do not realize what has occurred and if they ignore non-recurring expenses when finding sustainable income.

Question 37
L2FR-TB0028-1412
LOS: LOS-7150
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: medium
Which of the following statements regarding the quality of financial reporting is *most likely* to be accurate?

- Only fraudulent reports that diverge form GAAP compliance can diverge from economic reality.
- GAAP-compliant financial reports can diverge from economic reality if GAAP allows for biased choices.
- Non-GAAP-compliant accounting lies at the lowest level of the financial reporting spectrum.

Rationale

This Answer is Correct

Answer A is incorrect since GAAP-compliant reporting can diverge from economic reality if it allows for biased choices. Answer C is incorrect since the lowest level of the financial reporting spectrum is fictitious transactions.

Question 38
L2FR-TBB206-1412
LOS: LOS-7190
Lesson Reference: Lesson 3: Earnings Quality
Difficulty: medium
Which of the following companies is *most likely* to have the highest earnings quality?

- (selected) A company with positive serial correlation in earnings.
- A company with a high accruals component of earnings.
- A company with significantly higher net income versus cash flow from operations.

Rationale

This Answer is Correct

Positive serial correlation implies that earnings are related to a previous value, hence, exhibiting persistence and suggesting high-quality earnings. A high accruals component suggests low quality nonpersistent earnings, which will be the case if net income is significantly higher than operating cash flow over time.

Question 39
L2FR-TB0029-1412
LOS: LOS-7160
Lesson Reference: Lesson 2: Evaluating the Quality of Financial Reports
Difficulty: medium
Which of the following issues is *most likely* to arise specifically with the statement of cash flows?

- ○ Misclassification of cash flows in order to boost overall cash flow.
- ○ Misclassification of cash flows in order to boost CFF.
- ● Misclassification of cash flows in order to boost CFO.

Rationale

This Answer is Correct

Including non-operating items in operating cash flows may boost CFO and make the company look like it can generate more cash flows from its operating assets. A company would not usually boost overall cash flow through misclassification, since overall cash flow would not change. A company would not be motivated normally to boost CFF since this is not directly related to the ongoing operations of the company.

Question 40

L2R21TB-AC028-1512

LOS: LOS-7200

Lesson Reference: Lesson 3: Earnings Quality

Difficulty: medium

A firm and a major competitor both reported strong earnings growth in the current year, with this growth being well above average growth over the last several years. An analyst notes that the firm has a high level of accruals in current earnings, while its major competitor has a much lower level of accruals in current earnings. The firm with the high level of accruals will *most likely* revert to a mean growth rate:

- ○ More slowly than its competitor.
- ◉ More quickly than its competitor.
- ○ At the same rate as its competitor.

Rationale

❌ **More slowly than its competitor.**

Earnings are more consistent and sustainable when they have a high cash flow component and a low accruals component. Thus, the firm with a higher accruals component has a higher risk that its earnings are unsustainable and that its earnings will revert to their mean growth rate.

Rationale

✅ **More quickly than its competitor.**

Earnings are more consistent and sustainable when they have a high cash flow component and a low accruals component. Thus, the firm with a higher accruals component has a higher risk that its earnings are unsustainable and that its earnings will revert to their mean growth rate.

Rationale

❌ **At the same rate as its competitor.**

Earnings are more consistent and sustainable when they have a high cash flow component and a low accruals component. Thus, the firm with a higher accruals component has a higher risk that its earnings are unsustainable and that its earnings will revert to their mean growth rate.

Question 41
L2R21TB-AC014-1512
LOS: LOS-7150
Lesson Reference: Lesson 1: Quality of Financial Reports
Difficulty: medium
Based only on the choices below, which choice *best* reflects earnings management that could lessen the quality of financial results?

- ○ Increasing the reserve for uncollectible accounts during a recession and decreasing the reserve during periods of economic growth.
- ● Decreasing the reserve for uncollectible accounts during a recession and increasing the reserve during periods of economic growth.
- ○ Either increasing the reserve for uncollectible accounts during a recession and decreasing the reserve during periods of economic growth, or decreasing the reserve for uncollectible accounts during a recession and increasing the reserve during periods of economic growth.

Rationale
✖ **Increasing the reserve for uncollectible accounts during a recession and decreasing the reserve during periods of economic growth.**
Decreasing the reserve for uncollectible accounts during a recession does not make economic sense and only serves to add income to a company that may desperately need it. By raising the reserve during economic growth periods, the company is building reserves that can be called upon when in a recession. This process is known as smoothing and is a way to manipulate earnings. Although there are cases where increasing the reserve during bad times and decreasing the reserve during good times could reflect earnings management, there is no additional information to support that conclusion.

Rationale
✔ **Decreasing the reserve for uncollectible accounts during a recession and increasing the reserve during periods of economic growth.**
Decreasing the reserve for uncollectible accounts during a recession does not make economic sense and only serves to add income to a company that may desperately need it. By raising the reserve during economic growth periods, the company is building reserves that can be called upon when in a recession. This process is known as smoothing and is a way to manipulate earnings. Although there are cases where increasing the reserve during bad times and decreasing the reserve during good times could reflect earnings management, there is no additional information to support that conclusion.

Rationale
✖ **Either increasing the reserve for uncollectible accounts during a recession and decreasing the reserve during periods of economic growth, or decreasing the reserve for uncollectible accounts during a recession and increasing the reserve during periods of economic growth.**
Decreasing the reserve for uncollectible accounts during a recession does not make economic sense and only serves to add income to a company that may desperately need it. By raising the reserve during economic growth periods, the company is building reserves that can be called upon when in a recession. This process is known as smoothing and is a way to manipulate earnings. Although there are cases where increasing the reserve during bad times and decreasing the reserve during good times could reflect earnings management, there is no additional information to support that conclusion.