Question #1 of 63

Question ID: 1209158

Complete the following sentence. The cash component of income is __________ than the accrual component.

A) less persistent.

B) the same persistence.

C) more persistent.

Explanation

The accrual component of income (accruals) is less persistent than the cash component. By persistent we mean the income is sustainable; that is, a dollar of earnings today implies a dollar of earnings in future periods. Lower persistency is partially due to the estimates involved with accrual accounting.

(Study Session 6, Module 17.2, LOS 17.e)

Related Material

SchweserNotes - Book 2

Question #2 of 63

Question ID: 1209175

High Plains Tubular Company is a leading manufacturer and distributor of quality steel products used in energy, industrial, and automotive applications worldwide.

The U.S. steel industry has been challenged by competition from foreign producers located primarily in Asia. All of the U.S. producers are experiencing declining margins as labor costs continue to increase. In addition, the U.S. steel mills are technologically inferior to the foreign competitors. Also, the U.S. producers have significant environmental issues that remain unresolved.

High Plains is not immune from the problems of the industry and is currently in technical default under its bond covenants. The default is a result of the failure to meet certain coverage and turnover ratios. Earlier this year, High Plains and its bondholders entered into an agreement that will allow High Plains time to become compliant with the covenants. If High Plains is not in compliance by year end, the bondholders can immediately accelerate the maturity date of the bonds. In this case, High Plains would have no choice but to file bankruptcy.

High Plains follows U.S. GAAP. For the year ended 2008, High Plains received an unqualified opinion from its independent auditor. However, the auditor's opinion included an explanatory paragraph about High Plains' inability to continue as a going concern in the event its bonds remain in technical default.

At the end of 2008, High Plains' Chief Executive Officer (CEO) and Chief Financial Officer (CFO) filed the necessary certifications required by the Securities and Exchange Commission (SEC).

To get a better understanding of High Plains' financial situation, it is helpful to review High Plains' cash flow statement found in Exhibit 1 and selected financial footnotes found in Exhibit 2.

Exhibit 1: Cash Flow Statement

High Plains Tubular Cash Flow Statement		
	Year ended December 31,	
in thousands	**2008**	**2007**
Net income	$158,177	$121,164
Depreciation expense	34,078	31,295
Deferred taxes	7,697	11,407
Receivables	(144,087)	(24,852)
Inventory	(79,710)	(72,777)
Payables	36,107	22,455

Cash flow from operations	$12,262	$88,692
Cash flow from investing	($39,884)	($63,953)
Cash flow from financing	$82,676	$6,056
Change in cash	$55,054	$30,795

Exhibit 2: Selected Financial Footnotes

1. During 2008, High Plains' sales increased 27% over 2007. Its sales growth continues to significantly exceed the industry average. Sales are recognized when a firm order is received from the customer, the sales price is fixed and determinable, and collectability is reasonably assured.
2. The cost of inventories is determined using the last-in, first-out (LIFO) method. Had the first-in, first-out method been used, inventories would have been $152 million and $143 million higher as of December 31, 2008 and 2007, respectively.
3. Effective January 1, 2008, High Plains changed its depreciation method from the double-declining balance method to the straight-line method in order to be more comparable with the accounting practices of other firms within its industry. The change was not retroactively applied and only affects assets that were acquired on or after January 1, 2008.
4. High Plains made the following discretionary expenditures for maintenance and repair of plant and equipment and for advertising and marketing:

in millions	2008	2007	2006
Maintenance and repairs	$180	$184	$218
Advertising and marketing	94	108	150

5. During the fiscal year ended December 31, 2008, High Plains sold $50 million of its accounts receivable, with recourse, to an unrelated entity. All of the receivables were still outstanding at year end.
6. High Plains conducts some of its operations in facilities leased under noncancelable finance (capital) leases. Certain leases include renewal options with provisions for increased lease payments during the renewal term.
7. High Plains' average net operating assets at the end of 2008 and 2007 was $977.89 million and $642.83 million, respectively.

Does High Plains' accounting treatment of its finance (capital) leases and receivable sale lower its earnings quality?

A) Both treatments lower earnings quality.

B) The treatment of the receivables sale lowers earnings quality.

C) The treatment of finance (capital) leases lowers earnings quality.

Explanation

A finance (capital) lease is reported on the balance sheet as an asset and as a liability. In the income statement, the leased asset is depreciated and interest expense is recognized on the liability. Thus, capitalizing a lease *enhances* earnings quality. An *operating* lease lowers earnings quality.

The receivable sale, with recourse, lowers earnings quality. The sale is treated as a collection thereby increasing operating cash flow. However, High Plains is still responsible to the buyer in the event the receivables are not ultimately collected. Thus, the receivable sale is a collateralized borrowing arrangement that remains off-balance-sheet.

(Study Session 6, Module 17.3, LOS 17.h)

Related Material

SchweserNotes - Book 2

Question #3 of 63

Question ID: 1209174

Pysha Heavy Metals Ltd. supplies specialized metals to the chip fabrication industry.

Selected financial data for Pysha, as well as industry comparables, are shown below:

Pysha selected financial data (£ '000s):

	20x7	20x8	20x9
Sales	1,169	1,312	1,414
Accounts receivable	58.45	72.16	98.98

Industry average:

	20x7	20x8	20x9
DSO	22.6	22.8	22.4
Receivables turnover	16.2	16.0	16.3

Note: DSO and receivables turnover are based on year-end receivables.

Relative to industry average, for 20x9, Pysha's DSO and Receivables turnover are *most likely*:

DSO	Receivables turnover

A) Higher lower

B) Lower higher

C) Higher higher

Explanation

Pysha's DSO and receivables turnover is calculated as follows:

DSO	18.25	20.08	25.55
receviables turnover	20.00	18.18	14.29

For 20x9, industry DSO and receivables turnover are given as 22.4 and 16.3 respectively. Hence Pysha's DSO is higher and receivable turnover is lower than industry average.

(Study Session 6, Module 17.3, LOS 17.h)

Related Material

SchweserNotes - Book 2

Question #4 of 63

Question ID: 1209169

Alex Fisher, CFA, is examining the phenomenon of mean reversion on the earnings of several firms. Which of the following statements regarding mean reversion is *least* accurate?

A) Normal earnings should not be expected to continue indefinitely.

B) High earnings should not be expected to continue indefinitely.

C) Low earnings should not be expected to continue indefinitely.

Explanation

When examining net income, analysts should be aware that earnings at extreme levels tend to revert back to normal levels over time. This phenomenon is known as mean reversion. As a result of mean reversion, analysts must understand that extreme earnings (high or low) should not be expected to continue indefinitely.

(Study Session 6, Module 17.3, LOS 17.g)

Related Material

SchweserNotes - Book 2

Question #5 of 63

Question ID: 1209186

The *least* valuable source of information about a businesses' risk is:

A) Notes to financial statements.

B) Management discussion and analysis section of the annual report.

C) Auditor’s report.

Explanation

Because an audit report provides only historical information, such a report's usefulness as an information source is limited. Companies are required to make certain risk related disclosures in the notes to financial statements. Both GAAP and IFRS require companies to disclose risks related to pension benefits, contingent obligations and financial instruments. Ideally, companies should include principal risks that are unique to the business (as opposed to risks faced by most businesses) in their MD&A.

(Study Session 6, Module 17.5, LOS 17.m)

Related Material

SchweserNotes - Book 2

Question #6 of 63

Question ID: 1209176

William Jones, CFA, is analyzing the financial performance of two U.S. competitors in connection with a potential investment recommendation of their common stocks. He is particularly concerned about the quality of each company's financial results in 2007–2008 and in developing projections for 2009 and 2010 fiscal years.

Adams Company has been the largest company in the industry, but Jefferson Inc. has grown more rapidly in recent years. Adams's net sales in 2004 were 33-1/3% higher than Jefferson's but were only 18% above Jefferson's in 2008. During 2008, a slowing U.S. economy led to lower domestic revenue growth for both companies. The 10-k reports showed overall sales growth of 6% for Adams in 2008 compared to 7% for 2007 and 9% in 2006. Jefferson's gross sales rose almost 12% in 2008 versus 8% in 2007 and 10% in 2006. In the past three years, Jefferson has expanded its foreign business at a faster pace than Adams. In 2008, Jefferson's growth in overseas business was particularly impressive. According to the company's 10-k report, Jefferson offered a sales incentive to overseas customers. For those customers accepting the special sales discount, Jefferson shipped products to specific warehouses in foreign ports rather than directly to those customers' facilities.

In his initial review of Adams's and Jefferson's financial statements, Jones was concerned about the quality of the growth in Jefferson's sales, considerably higher accounts receivables, and the impact of overall accruals on earnings quality. He noted that Jefferson had instituted an accounting change in 2008. The economic life for new plant and equipment investments was determined to be five years longer than for previous investments. For Adams, he noted that the higher level of inventories at the end of 2008 might be cause for concern in light of a further slowdown expected in the U.S. economy in 2009.

The accompanying table shows financial data for both companies' Form 10-k reports for 2006–2008 used by Jones for his analysis. To evaluate sales quality, he focused on trends in sales and related expenses for both companies as well as cash collections and receivables comparisons. Inventory trends relative to sales and the number of days' sales outstanding in inventory were determined for both companies. Expense trends were examined for Adams and Jefferson relative to sales growth and accrual ratios on a balance sheet and cash flow basis were developed as overall measures of earnings quality.

	Adams Company				**Jefferson Inc.**		
($ in thousands)	**2006**	**2007**	**2008**		**2006**	**2007**	**2008**
Gross sales	32,031	34,273	36,330		25,625	27,675	30,900
Sales discounts, returns, and allowances	781	836	886		625	675	900

Net sales	31,250	33,438	35,444		25,000	27,000	30,000
Cost of goods sold	15,312	16,384	17,367		12,250	13,250	15,500
SG&A expenses	9,028	9,660	10,240		7,222	7,800	8,200
Depreciation expense	625	669	709		500	515	516
Interest expense	400	428	454		360	366	396
Income before taxes	5,835	6,243	6,618		4,668	5,069	5,388
Taxes (tax rate 40%)	2,334	2,497	2,647		2,000	2,028	2,155
Net income	3,501	3,746	3,971		2,668	3,041	3,233
Dividends	3,000	3,180	3,307		2,460	2,760	2,880
Net addition to retained earnings	501	566	664		208	281	353
Balance Sheet							
Cash and equivalents	150	160	170		120	130	120
Short-term marketable securities	250	325	345		200	217	195
Accounts receivable (net)	15,875	16,758	17,763		12,700	13,000	15,892
Inventories	6,500	6,850	7,800		5,200	5,200	4,500
PP&E (net of depreciation)	8,562	8,991	9,440		6,850	7,057	7,200
Total assets	31,337	33,084	35,518		25,070	25,604	27,907
Accounts payable	7,062	7,880	9,300		6,050	6,100	6,398
Other current liabilities	337	400	450		270	373	1,525
Long-term debt	7,500	7,800	8,100		6,000	6,100	6,600
Common stock	15,000	15,000	15,000		12,000	12,000	12,000
Retained earnings	1,438	2,004	2,668		750	1,031	1,384
Total liabilities and shareholders	31,337	33,084	35,518		25,070	25,604	27,907

equity						
% change gross sales		7.0%	6.0%		8.0%	11.7%
% change sales discounts and allowances		6.0%	6.0%		8.0%	33.3%
% change net sales		7.0%	6.0%		8.0%	11.1%
% change cost of goods sold		7.0%	6.0%		8.0%	17.0%
% change in SG&A		6.0%	6.0%		8.0%	5.1%
% change in depreciation expense		6.0%	6.0%		3.0%	0.2%
% change in accounts receivable		6.0%	6.0%		2.0%	22.3%
% change in inventories		5.0%	13.8%		0.0%	(13.5%)
Revenues % cash collections	1.03	1.03	1.03	1.0	1.0	1.1
Days inventory outstanding	155	153	164	144	143	106
Balance sheet accrual ratio	3.4%	3.5%	3.9%	2.0%	2.4%	10.1%
Cash flow accrual ratio	3.4%	3.5%	3.8%	2.0%	2.0%	4.3%

The quality of earnings as measured by cash-flow-based accruals ratios showed:

A) Jefferson's 2008 accrual ratio exceeded Adams's ratio for the first time in the 2006–2008 period, thus demonstrating significant improvement in earnings

B) Jefferson's higher accruals ratio in 2008 compared to 2007 and relative to Adams's in 2008 indicates Jefferson's higher earnings quality.

C) Jefferson's 2008 accrual ratio exceeded Adams's ratio for the first time in the 2006–2008 period, indicating a decline in earnings quality compared to previous

Explanation

The lower the ratio, the higher will be the earnings quality. Jefferson's ratio rose sharply in 2008 and exceeded Adams's ratio for the first time in the three years. Thus, Jefferson's earnings quality is lower.

(Study Session 6, Module 17.3, LOS 17.h)

Related Material

SchweserNotes - Book 2

Question #7 of 63

Question ID: 1209128

Which of the following items is *least likely* to involve the use of subjective measurement estimates by management?

A) Use of straight-line depreciation method to depreciate tangible assets. ✗

B) Use of FIFO (first in-first out) to cost inventories. ✗

C) Use of criteria to determine treatment as an extraordinary item. ✓

Explanation

The use of criteria to determine treatment as an extraordinary item (i.e. Is the item within management's discretion? Is the event likely to recur in the foreseeable future?) does not involve numerical and subjective estimates per se. It is more a test of qualitative factors to determine the proper classification. Contrast this to FIFO, which is clearly a numerical estimate since an alternative of using LIFO (last in-first out) is possible and this will result in a different reported amount than FIFO. The same argument can be made for the use of the straight-line method since an alternative of using the declining-balance method is possible to depreciate tangible assets.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #8 of 63

Question ID: 1209181

Samuel Maskin, CFA is evaluating the financial statements of Northern Energy Inc. The following is an extract from Northern's cash flow statement for the past three years:

	20x6	20x5	20x4
Net Income	$1,023	$988	$744
Depreciation	$187	$145	$128
Restructuring Charges	$(108)	$(104)	$212
Accounts receivable	$(172)	$(145)	$(33)
Inventories	$(418)	$(202)	$(180)
Accounts Payable	$38	$37	$33
OCF	$550	$719	$904

The restructuring charges for Northern has *most likely*:

A) Reduced reported earnings in 20x4 while increasing reported earnings in 20x5 and 20x6.

B) Increased reported earnings in 20x6 while reducing reported earnings in 20x4 and 20x5.

C) Increased reported earnings for 20x4 while reducing reported earnings in 20x5 and 20x6.

Explanation

Restructuring charges contribute positively to 20x4 cash flow indicating that it was a non-cash charge against that year's income. In the following two years, there is a reversal of that charge leading to an artificial increase in reported earnings for 20x5 and 20x6.

(Study Session 6, Module 17.4, LOS 17.j)

Related Material

SchweserNotes - Book 2

Question #9 of 63

Question ID: 1209138

With regard to specific measures to analyze in detecting manipulation in the financial reporting process, which of the following statements is the *least* accurate?

A) A decreasing days' sales outstanding (DSO) measure may be an indication of lower quality revenue.

B) Negative nonrecurring or non-operating items may be indicative of misclassifying an operating expense.

C) An increasing days' inventory on hand (DOH) measure may be indicative of obsolete inventory.

Explanation

Days' sales outstanding (DSO) measures the number of days it takes to convert receivables into cash and is calculated by dividing the number of days in the period by the accounts receivable turnover ratio. An increasing DSO (decreasing receivables turnover) may be an indication of lower quality revenue; that is, the longer it takes to collect from customers, the more likely the receivables will turn into bad debt.

Days' inventory on hand (DOH) is equal to the number of days in the period divided by inventory turnover ratio and it measures the number of days it takes to sell inventory. An increasing DOH may be indicative of obsolete inventory.

Analysts should compare changes in the core operating margin over time and look for negative nonrecurring (e.g., restructuring charges, asset impairments, and write-downs) or non-operating items that occurred when the ratio increased. This may be the result of misclassifying an operating expense.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #10 of 63

Question ID: 1209157

Consider the following statements:

Statement 1:	Compared to the cash basis of accounting, the accrual basis of accounting provides more timely information about future cash flows.
Statement 2:	Compared to the cash basis of accounting, the accrual basis requires more use of discretion than the cash basis.

Are these statements CORRECT?

A) No, because it is actually the cash basis of accounting that results in more difficulty in properly assigning revenues and expenses to the appropriate

B) Yes.

C) No, because it is actually the cash basis of accounting that provides more timely and relevant information to users about future cash flows.

Explanation

Users of financial information seek timely information about future cash flows. The accrual basis of accounting provides this information at the earliest appearance of objective evidence. Thus, accrual accounting provides more timely and relevant information to users. The cash basis is more concerned with recording cash flows for transactions that have already occurred.

Accrual accounting (not cash-based accounting) necessitates the use of discretion because of the many estimates and judgments involved with assigning revenue and expense to the appropriate periods.

(Study Session 6, Module 17.2, LOS 17.e)

Related Material

SchweserNotes - Book 2

Question #11 of 63

Question ID: 1209140

Galaxy Company recognized a restructuring charge in its year-end income statement. Similar restructuring charges have occurred in the past. In addition, Galaxy recognized an extraordinary loss. Galaxy uses the term "operational earnings" when discussing its financial results. According to Galaxy, "operational earnings" excludes special nonrecurring transactions such as restructuring charges, discontinued operations, and extraordinary items. Should the restructuring charge and extraordinary loss be included or excluded from "operational earnings" for analytical purposes?

A) Both are excluded.

B) One is included.

C) Both are included.

Explanation

The restructuring charge does not appear to be nonrecurring; thus, it should be included in "operational earnings." By definition, an extraordinary loss is unusual in nature and infrequent in occurrence. Therefore, the extraordinary loss should be excluded from "operational earnings."

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #12 of 63

Question ID: 1209159

Complete the following sentence. An analyst would apply ________ to the cash component of income compared to the accrual component when evaluating company performance.

A) a lower weighting.

B) the same weighting.

C) a higher weighting.

Explanation

Since the cash component has more sustainability in the future than the accrual component, an analyst would apply a higher weighting to the cash component of income than the accrual component when evaluating company performance.

(Study Session 6, Module 17.2, LOS 17.e)

Related Material

SchweserNotes - Book 2

Question #13 of 63

Question ID: 1209137

Duster Corporation's year-end income statement reported the following:

Operating income		$187,000
Results from discontinued operations:		
Loss from segment operations		
(net of $1,440 tax effect)	($2,160)	
Gain on segment disposal		
(net of $8,640 tax effect)	12,960	10,800
Gain on sale of equipment		3,400
Interest expense		12,400
Extraordinary loss		
(net of $2,200 tax benefit)		3,300
Income tax expense		71,200

Calculate Duster's income from continuing operations for the year.

A) $100,200.

B) \$106,800.

C) \$103,500.

Explanation

Income from continuing operations includes all revenues and expenses except discontinued operations and extraordinary items: \$187,000 operating income + \$3,400 gain on sale of equipment – \$12,400 interest expense – \$71,200 income tax expense = \$106,800.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #14 of 63

Question ID: 1209146

William Jones, CFA, is analyzing the financial performance of two U.S. competitors in connection with a potential investment recommendation of their common stocks. He is particularly concerned about the quality of each company's financial results in 2007–2008 and in developing projections for 2009 and 2010 fiscal years.

Adams Company has been the largest company in the industry, but Jefferson Inc. has grown more rapidly in recent years. Adams's net sales in 2004 were 33-1/3% higher than Jefferson's but were only 18% above Jefferson's in 2008. During 2008, a slowing U.S. economy led to lower domestic revenue growth for both companies. The 10-k reports showed overall sales growth of 6% for Adams in 2008 compared to 7% for 2007 and 9% in 2006. Jefferson's gross sales rose almost 12% in 2008 versus 8% in 2007 and 10% in 2006. In the past three years, Jefferson has expanded its foreign business at a faster pace than Adams. In 2008, Jefferson's growth in overseas business was particularly impressive. According to the company's 10-k report, Jefferson offered a sales incentive to overseas customers. For those customers accepting the special sales discount, Jefferson shipped products to specific warehouses in foreign ports rather than directly to those customers' facilities.

In his initial review of Adams's and Jefferson's financial statements, Jones was concerned about the quality of the growth in Jefferson's sales, considerably higher accounts receivables, and the impact of overall accruals on earnings quality. He noted that Jefferson had instituted an accounting change in 2008. The economic life for new plant and equipment investments was determined to be five years longer than for previous investments. For Adams, he noted that the higher level of inventories at the end of 2008 might be cause for concern in light of a further slowdown expected in the U.S. economy in 2009.

The accompanying table shows financial data for both companies' Form 10-k reports for 2006–2008 used by Jones for his analysis. To evaluate sales quality, he focused on trends in sales and related expenses for both companies as well as cash collections and receivables comparisons. Inventory trends relative to sales and the number of days' sales outstanding in inventory were determined for both companies. Expense trends were examined for Adams and Jefferson relative to sales growth and accrual ratios on a balance sheet and cash flow basis were developed as overall measures of earnings quality.

	Adams Company				**Jefferson Inc.**		
($ in thousands)	**2006**	**2007**	**2008**		**2006**	**2007**	**2008**
Gross sales	32,031	34,273	36,330		25,625	27,675	30,900
Sales discounts, returns, and allowances	781	836	886		625	675	900

Net sales	31,250	33,438	35,444		25,000	27,000	30,000
Cost of goods sold	15,312	16,384	17,367		12,250	13,250	15,500
SG&A expenses	9,028	9,660	10,240		7,222	7,800	8,200
Depreciation expense	625	669	709		500	515	516
Interest expense	400	428	454		360	366	396
Income before taxes	5,835	6,243	6,618		4,668	5,069	5,388
Taxes (tax rate 40%)	2,334	2,497	2,647		2,000	2,028	2,155
Net income	3,501	3,746	3,971		2,668	3,041	3,233
Dividends	3,000	3,180	3,307		2,460	2,760	2,880
Net addition to retained earnings	501	566	664		208	281	353
Balance Sheet							
Cash and equivalents	150	160	170		120	130	120
Short-term marketable securities	250	325	345		200	217	195
Accounts receivable (net)	15,875	16,758	17,763		12,700	13,000	15,892
Inventories	6,500	6,850	7,800		5,200	5,200	4,500
PP&E (net of depreciation)	8,562	8,991	9,440		6,850	7,057	7,200
Total assets	31,337	33,084	35,518		25,070	25,604	27,907
Accounts payable	7,062	7,880	9,300		6,050	6,100	6,398
Other current liabilities	337	400	450		270	373	1,525
Long-term debt	7,500	7,800	8,100		6,000	6,100	6,600
Common stock	15,000	15,000	15,000		12,000	12,000	12,000
Retained earnings	1,438	2,004	2,668		750	1,031	1,384
Total liabilities and shareholders	31,337	33,084	35,518		25,070	25,604	27,907

equity							
% change gross sales		7.0%	6.0%			8.0%	11.7%
% change sales discounts and allowances		6.0%	6.0%			8.0%	33.3%
% change net sales		7.0%	6.0%			8.0%	11.1%
% change cost of goods sold		7.0%	6.0%			8.0%	17.0%
% change in SG&A		6.0%	6.0%			8.0%	5.1%
% change in depreciation expense		6.0%	6.0%			3.0%	0.2%
% change in accounts receivable		6.0%	6.0%			2.0%	22.3%
% change in inventories		5.0%	13.8%			0.0%	(13.5%)
Revenues % cash collections	1.03	1.03	1.03		1.0	1.0	1.1
Days inventory outstanding	155	153	164		144	143	106
Balance sheet accrual ratio	3.4%	3.5%	3.9%		2.0%	2.4%	10.1%
Cash flow accrual ratio	3.4%	3.5%	3.8%		2.0%	2.0%	4.3%

Comparisons of expense trends in 2007–2008 showed:

A) higher growth of Adams's SG&A and depreciation expense versus Jefferson's may indicate more effective expense control by Jefferson in a slowing domestic

B) higher growth of Adams's SG&A and depreciation expense versus Jefferson's; the small change in Jefferson's depreciation may relate to the change in depreciation

C) Jefferson's management appeared to have managed SG&A and depreciation expenses more effectively than Adams's; there was a small increase in Jefferson's

Explanation

The more favorable trends in Jefferson's expenses may reflect more aggressive depreciation accounting and controls imposed on discretionary expenses to offset declining gross profit margins.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #15 of 63

Question ID: 1209155

Pritesh Deshmukh, CFA is analyzing the financial statements of Baza Restaurants Inc. Deshmukh wants to use the Beneish model to evaluate the probability of earnings manipulation.

Deshmukh makes the following statements:

1. Depreciation index of less than 1 would indicate that the company is depreciating assets at a lower rate than in prior years.
2. Sales growth index of more than 1 indicates revenue inflation.

Which of the statements by Deshmukh are *most* accurate?

A) Statement 2 only.

B) Statement 1 only.

C) None of the statements is accurate.

Explanation

Statement 1 is incorrect. Depreciation index of less than 1 indicates that the company is depreciating assets at a higher rate than in prior years. Statement 2 is incorrect. Sales growth index of more than 1 simply implies that the growth in sales is positive. While not a measure of manipulation by itself, growth companies tend to find themselves under pressure to manipulate earnings to meet ongoing expectations.

(Study Session 6, Module 17.2, LOS 17.d)

Related Material

SchweserNotes - Book 2

Question #16 of 63

Question ID: 1209184

Which of the following is *least likely* an indicator of biased measurement in assessing balance sheet quality?

A) Understatement of impairment charges for property, plan and equipment.

B) Company's investment in debt securities of other companies, carried on the books at market value.

C) Overly high assumed discount rate for pension obligations.

Explanation

Carrying investments in debt (or equity) securities at market value enhances balance sheet quality and does not introduce a bias in the estimate. Understatement of impairment charges on PP&E overstates value of PP&E. High discount rate reduces the value of PBO and hence improves the funded position reflected on the balance sheet.

(Study Session 6, Module 17.5, LOS 17.k)

Related Material

SchweserNotes - Book 2

Question #17 of 63

Question ID: 1209136

Analyst Jane Kilgore is worried that some of Maxwell Research's accrual accounting practices will lead to excessive operating earnings recognition in the near-term. Examples of Kilgore's concerns include the following:

- Accelerated revenue recognition of service agreements.
- Classification of recurring revenue as nonrecurring revenue.
- Understated inventory obsolescence.

Which of Kilgore's concerns is *least* likely to overstate current operating earnings?

A) Understated inventory obsolescence.

B) Classification of recurring revenue as nonrecurring revenue.

C) Accelerated revenue recognition of service agreements.

Explanation

Classification of recurring revenue as nonrecurring revenue will *understate* current operating earnings. The other two items act to overstate revenue and understate expenses.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #18 of 63

Question ID: 1209180

Samuel Maskin, CFA is evaluating the financial statements of Northern Energy Inc. The following is an extract from Northern's cash flow statement for the past three years:

	20x6	20x5	20x4
Net Income	$1,023	$988	$744
Depreciation	$187	$145	$128
Restructuring Charges	$(108)	$(104)	$212
Accounts receivable	$(172)	$(145)	$(33)
Inventories	$(418)	$(202)	$(180)
Accounts Payable	$38	$37	$33
OCF	$550	$719	$904

Which of the following conclusions is *least likely* for Northern?

A) Days sales outstanding is probably increasing.

B) Northern is stretching payables.

C) Northern may have accelerated revenue recognition.

Explanation

We are not provided with income statement data such as revenues and COGS and hence have to make inferences from the information provided. Accounts payable seem to be stable and decreasing as a percentage of net income making the conclusion of stretching payables least likely. Revenue acceleration can be concluded based on large increase in inventory in 20x6 (possibly reflecting returns from customers) combined with increases in accounts receivable over time. Increases in accounts receivable (relative to earnings) also would indicate that days sales outstanding would most likely be increasing.

(Study Session 6, Module 17.4, LOS 17.j)

Related Material

SchweserNotes - Book 2

Question #19 of 63

Question ID: 1209177

William Jones, CFA, is analyzing the financial performance of two U.S. competitors in connection with a potential investment recommendation of their common stocks. He is particularly concerned about the quality of each company's financial results in 2007–2008 and in developing projections for 2009 and 2010 fiscal years.

Adams Company has been the largest company in the industry, but Jefferson Inc. has grown more rapidly in recent years. Adams's net sales in 2004 were 33-1/3% higher than Jefferson's but were only 18% above Jefferson's in 2008. During 2008, a slowing U.S. economy led to lower domestic revenue growth for both companies. The 10-k reports showed overall sales growth of 6% for Adams in 2008 compared to 7% for 2007 and 9% in 2006. Jefferson's gross sales rose almost 12% in 2008 versus 8% in 2007 and 10% in 2006. In the past three years, Jefferson has expanded its foreign business at a faster pace than Adams. In 2008, Jefferson's growth in overseas business was particularly impressive. According to the company's 10-k report, Jefferson offered a sales incentive to overseas customers. For those customers accepting the special sales discount, Jefferson shipped products to specific warehouses in foreign ports rather than directly to those customers' facilities.

In his initial review of Adams's and Jefferson's financial statements, Jones was concerned about the quality of the growth in Jefferson's sales, considerably higher accounts receivables, and the impact of overall accruals on earnings quality. He noted that Jefferson had instituted an accounting change in 2008. The economic life for new plant and equipment investments was determined to be five years longer than for previous investments. For Adams, he noted that the higher level of inventories at the end of 2008 might be cause for concern in light of a further slowdown expected in the U.S. economy in 2009.

The accompanying table shows financial data for both companies' Form 10-k reports for 2006–2008 used by Jones for his analysis. To evaluate sales quality, he focused on trends in sales and related expenses for both companies as well as cash collections and receivables comparisons. Inventory trends relative to sales and the number of days' sales outstanding in inventory were determined for both companies. Expense trends were examined for Adams and Jefferson relative to sales growth and accrual ratios on a balance sheet and cash flow basis were developed as overall measures of earnings quality.

	Adams Company			**Jefferson Inc.**		
($ in thousands)	**2006**	**2007**	**2008**	**2006**	**2007**	**2008**
Gross sales	32,031	34,273	36,330	25,625	27,675	30,900
Sales discounts, returns, and allowances	781	836	886	625	675	900

Net sales	31,250	33,438	35,444		25,000	27,000	30,000
Cost of goods sold	15,312	16,384	17,367		12,250	13,250	15,500
SG&A expenses	9,028	9,660	10,240		7,222	7,800	8,200
Depreciation expense	625	669	709		500	515	516
Interest expense	400	428	454		360	366	396
Income before taxes	5,835	6,243	6,618		4,668	5,069	5,388
Taxes (tax rate 40%)	2,334	2,497	2,647		2,000	2,028	2,155
Net income	3,501	3,746	3,971		2,668	3,041	3,233
Dividends	3,000	3,180	3,307		2,460	2,760	2,880
Net addition to retained earnings	501	566	664		208	281	353
Balance Sheet							
Cash and equivalents	150	160	170		120	130	120
Short-term marketable securities	250	325	345		200	217	195
Accounts receivable (net)	15,875	16,758	17,763		12,700	13,000	15,892
Inventories	6,500	6,850	7,800		5,200	5,200	4,500
PP&E (net of depreciation)	8,562	8,991	9,440		6,850	7,057	7,200
Total assets	31,337	33,084	35,518		25,070	25,604	27,907
Accounts payable	7,062	7,880	9,300		6,050	6,100	6,398
Other current liabilities	337	400	450		270	373	1,525
Long-term debt	7,500	7,800	8,100		6,000	6,100	6,600
Common stock	15,000	15,000	15,000		12,000	12,000	12,000
Retained earnings	1,438	2,004	2,668		750	1,031	1,384
Total liabilities and shareholders	31,337	33,084	35,518		25,070	25,604	27,907

equity							
% change gross sales		7.0%	6.0%			8.0%	11.7%
% change sales discounts and allowances		6.0%	6.0%			8.0%	33.3%
% change net sales		7.0%	6.0%			8.0%	11.1%
% change cost of goods sold		7.0%	6.0%			8.0%	17.0%
% change in SG&A		6.0%	6.0%			8.0%	5.1%
% change in depreciation expense		6.0%	6.0%			3.0%	0.2%
% change in accounts receivable		6.0%	6.0%			2.0%	22.3%
% change in inventories		5.0%	13.8%			0.0%	(13.5%)
Revenues % cash collections	1.03	1.03	1.03		1.0	1.0	1.1
Days inventory outstanding	155	153	164		144	143	106
Balance sheet accrual ratio	3.4%	3.5%	3.9%		2.0%	2.4%	10.1%
Cash flow accrual ratio	3.4%	3.5%	3.8%		2.0%	2.0%	4.3%

Based on the financial results of Adams and Jefferson in 2007 and 2008, the company demonstrating the lower earnings quality would be:

A) Adams due to slower revenue growth, higher expense growth compared to Jefferson, possible inventory obsolescence related to higher 2008 inventories

B) Jefferson due to sharply higher accruals ratios and less conservative accounting methods indicated by the change in depreciation policies and the impact of

C) Adams due to lower cash collection measures, possible inventory obsolescence related to higher 2008 inventories despite slowing customer demand, higher

Explanation

According to the simple measures of earnings quality, balance sheet, and cash flow accruals ratios, Jefferson's earnings quality in 2008 was lower than its 2007 levels and relative to Adams's. The more aggressive accounting treatment for the overseas special offer lowered the quality of revenues and may have understated inventories if some of these customers did not take delivery of the shipments. Jefferson also instituted a more liberal policy toward depreciable lives versus Adams, another indicator of lower earnings quality.

(Study Session 6, Module 17.3, LOS 17.h)

Related Material

SchweserNotes - Book 2

Question #20 of 63

Question ID: 1209127

Errors that affect multiple financial statement elements are *most likely* to arise from:

A) measurement and timing issues. ✓

B) classification issues. ✗

C) compound issues. ✗

Explanation

Measurement and timing issues typically affect multiple financial statement elements while classification issues typically affects categorization of a specific element in a financial statement.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #21 of 63

Question ID: 1209154

In the context of the Beneish model to evaluate the probability of earnings manipulation, an increase in Days Sales Receivable Index is *least likely* to signify:

A) a decrease in probability of earnings manipulation. ✓

B) an increase in M-score. ✗

C) revenue inflation. ✗

Explanation

An increase in Days Sales Receivable Index indicates revenue inflation and increases the M-score, thereby increasing the probability of earnings manipulation.

(Study Session 6, Module 17.2, LOS 17.c)

Related Material

SchweserNotes - Book 2

Question #22 of 63

Question ID: 1209123

High results quality is *most likely* demonstrated by:

A) an adequate level of return that is sustainable.

B) high level of earnings determined conservatively.

C) GAAP compliant financial reports that are decision useful.

Explanation

High results quality occurs if the level of earnings provides an adequate level of return and that the earnings are sustainable.

(Study Session 6, Module 17.1, LOS 17.a)

Related Material

SchweserNotes - Book 2

Question #23 of 63

Question ID: 1209145

William Jones, CFA, is analyzing the financial performance of two U.S. competitors in connection with a potential investment recommendation of their common stocks. He is particularly concerned about the quality of each company's financial results in 2007–2008 and in developing projections for 2009 and 2010 fiscal years.

Adams Company has been the largest company in the industry, but Jefferson Inc. has grown more rapidly in recent years. Adams's net sales in 2004 were 33-1/3% higher than Jefferson's but were only 18% above Jefferson's in 2008. During 2008, a slowing U.S. economy led to lower domestic revenue growth for both companies. The 10-k reports showed overall sales growth of 6% for Adams in 2008 compared to 7% for 2007 and 9% in 2006. Jefferson's gross sales rose almost 12% in 2008 versus 8% in 2007 and 10% in 2006. In the past three years, Jefferson has expanded its foreign business at a faster pace than Adams. In 2008, Jefferson's growth in overseas business was particularly impressive. According to the company's 10-k report, Jefferson offered a sales incentive to overseas customers. For those customers accepting the special sales discount, Jefferson shipped products to specific warehouses in foreign ports rather than directly to those customers' facilities.

In his initial review of Adams's and Jefferson's financial statements, Jones was concerned about the quality of the growth in Jefferson's sales, considerably higher accounts receivables, and the impact of overall accruals on earnings quality. He noted that Jefferson had instituted an accounting change in 2008. The economic life for new plant and equipment investments was determined to be five years longer than for previous investments. For Adams, he noted that the higher level of inventories at the end of 2008 might be cause for concern in light of a further slowdown expected in the U.S. economy in 2009.

The accompanying table shows financial data for both companies' Form 10-k reports for 2006–2008 used by Jones for his analysis. To evaluate sales quality, he focused on trends in sales and related expenses for both companies as well as cash collections and receivables comparisons. Inventory trends relative to sales and the number of days' sales outstanding in inventory were determined for both companies. Expense trends were examined for Adams and Jefferson relative to sales growth and accrual ratios on a balance sheet and cash flow basis were developed as overall measures of earnings quality.

	Adams Company				**Jefferson Inc.**		
($ in thousands)	**2006**	**2007**	**2008**		**2006**	**2007**	**2008**
Gross sales	32,031	34,273	36,330		25,625	27,675	30,900
Sales discounts, returns, and allowances	781	836	886		625	675	900

Net sales	31,250	33,438	35,444		25,000	27,000	30,000
Cost of goods sold	15,312	16,384	17,367		12,250	13,250	15,500
SG&A expenses	9,028	9,660	10,240		7,222	7,800	8,200
Depreciation expense	625	669	709		500	515	516
Interest expense	400	428	454		360	366	396
Income before taxes	5,835	6,243	6,618		4,668	5,069	5,388
Taxes (tax rate 40%)	2,334	2,497	2,647		2,000	2,028	2,155
Net income	3,501	3,746	3,971		2,668	3,041	3,233
Dividends	3,000	3,180	3,307		2,460	2,760	2,880
Net addition to retained earnings	501	566	664		208	281	353
Balance Sheet							
Cash and equivalents	150	160	170		120	130	120
Short-term marketable securities	250	325	345		200	217	195
Accounts receivable (net)	15,875	16,758	17,763		12,700	13,000	15,892
Inventories	6,500	6,850	7,800		5,200	5,200	4,500
PP&E (net of depreciation)	8,562	8,991	9,440		6,850	7,057	7,200
Total assets	31,337	33,084	35,518		25,070	25,604	27,907
Accounts payable	7,062	7,880	9,300		6,050	6,100	6,398
Other current liabilities	337	400	450		270	373	1,525
Long-term debt	7,500	7,800	8,100		6,000	6,100	6,600
Common stock	15,000	15,000	15,000		12,000	12,000	12,000
Retained earnings	1,438	2,004	2,668		750	1,031	1,384
Total liabilities and shareholders	31,337	33,084	35,518		25,070	25,604	27,907

equity							
% change gross sales		7.0%	6.0%			8.0%	11.7%
% change sales discounts and allowances		6.0%	6.0%			8.0%	33.3%
% change net sales		7.0%	6.0%			8.0%	11.1%
% change cost of goods sold		7.0%	6.0%			8.0%	17.0%
% change in SG&A		6.0%	6.0%			8.0%	5.1%
% change in depreciation expense		6.0%	6.0%			3.0%	0.2%
% change in accounts receivable		6.0%	6.0%			2.0%	22.3%
% change in inventories		5.0%	13.8%			0.0%	(13.5%)
Revenues % cash collections	1.03	1.03	1.03		1.0	1.0	1.1
Days inventory outstanding	155	153	164		144	143	106
Balance sheet accrual ratio	3.4%	3.5%	3.9%		2.0%	2.4%	10.1%
Cash flow accrual ratio	3.4%	3.5%	3.8%		2.0%	2.0%	4.3%

Jones also observed that inventory and cost of goods sold comparisons showed:

A) Jefferson's inventory decline suggests possible problems in inventory management to meet the stronger customer demand from the special offer;

B) Jefferson's inventory increase and large increase in cost of goods sold may be related to the success of the special offer; Adams's large increase in inventories

C) Jefferson's inventory levels may be understated and sales overstated to the extent of product shipments for the special offer; Adams's inventory increase

Explanation

Jefferson's revenue and inventory levels may be distorted by revenue recognition for new business from the special offer. Although the customers agreed to delay delivery of the products, recognition of these sales prior to customer delivery lowers the quality of these sales and understates inventory. Inventory is understated if the sale is not totally complete.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #24 of 63

Question ID: 1209147

William Jones, CFA, is analyzing the financial performance of two U.S. competitors in connection with a potential investment recommendation of their common stocks. He is particularly concerned about the quality of each company's financial results in 2007– 2008 and in developing projections for 2009 and 2010 fiscal years.

Adams Company has been the largest company in the industry, but Jefferson Inc. has grown more rapidly in recent years. Adams's net sales in 2004 were 33-1/3% higher than Jefferson's but were only 18% above Jefferson's in 2008. During 2008, a slowing U.S. economy led to lower domestic revenue growth for both companies. The 10-k reports showed overall sales growth of 6% for Adams in 2008 compared to 7% for 2007 and 9% in 2006. Jefferson's gross sales rose almost 12% in 2008 versus 8% in 2007 and 10% in 2006. In the past three years, Jefferson has expanded its foreign business at a faster pace than Adams. In 2008, Jefferson's growth in overseas business was particularly impressive. According to the company's 10-k report, Jefferson offered a sales incentive to overseas customers. For those customers accepting the special sales discount, Jefferson shipped products to specific warehouses in foreign ports rather than directly to those customers' facilities.

In his initial review of Adams's and Jefferson's financial statements, Jones was concerned about the quality of the growth in Jefferson's sales, considerably higher accounts receivables, and the impact of overall accruals on earnings quality. He noted that Jefferson had instituted an accounting change in 2008. The economic life for new plant and equipment investments was determined to be five years longer than for previous investments. For Adams, he noted that the higher level of inventories at the end of 2008 might be cause for concern in light of a further slowdown expected in the U.S. economy in 2009.

The accompanying table shows financial data for both companies' Form 10-k reports for 2006–2008 used by Jones for his analysis. To evaluate sales quality, he focused on trends in sales and related expenses for both companies as well as cash collections and receivables comparisons. Inventory trends relative to sales and the number of days' sales outstanding in inventory were determined for both companies. Expense trends were examined for Adams and Jefferson relative to sales growth and accrual ratios on a balance sheet and cash flow basis were developed as overall measures of earnings quality.

	Adams Company				**Jefferson Inc.**		
($ in thousands)	**2006**	**2007**	**2008**		**2006**	**2007**	**2008**
Gross sales	32,031	34,273	36,330		25,625	27,675	30,900
Sales discounts, returns, and allowances	781	836	886		625	675	900

Net sales	31,250	33,438	35,444		25,000	27,000	30,000
Cost of goods sold	15,312	16,384	17,367		12,250	13,250	15,500
SG&A expenses	9,028	9,660	10,240		7,222	7,800	8,200
Depreciation expense	625	669	709		500	515	516
Interest expense	400	428	454		360	366	396
Income before taxes	5,835	6,243	6,618		4,668	5,069	5,388
Taxes (tax rate 40%)	2,334	2,497	2,647		2,000	2,028	2,155
Net income	3,501	3,746	3,971		2,668	3,041	3,233
Dividends	3,000	3,180	3,307		2,460	2,760	2,880
Net addition to retained earnings	501	566	664		208	281	353
Balance Sheet							
Cash and equivalents	150	160	170		120	130	120
Short-term marketable securities	250	325	345		200	217	195
Accounts receivable (net)	15,875	16,758	17,763		12,700	13,000	15,892
Inventories	6,500	6,850	7,800		5,200	5,200	4,500
PP&E (net of depreciation)	8,562	8,991	9,440		6,850	7,057	7,200
Total assets	31,337	33,084	35,518		25,070	25,604	27,907
Accounts payable	7,062	7,880	9,300		6,050	6,100	6,398
Other current liabilities	337	400	450		270	373	1,525
Long-term debt	7,500	7,800	8,100		6,000	6,100	6,600
Common stock	15,000	15,000	15,000		12,000	12,000	12,000
Retained earnings	1,438	2,004	2,668		750	1,031	1,384
Total liabilities and shareholders	31,337	33,084	35,518		25,070	25,604	27,907

equity						
% change gross sales		7.0%	6.0%		8.0%	11.7%
% change sales discounts and allowances		6.0%	6.0%		8.0%	33.3%
% change net sales		7.0%	6.0%		8.0%	11.1%
% change cost of goods sold		7.0%	6.0%		8.0%	17.0%
% change in SG&A		6.0%	6.0%		8.0%	5.1%
% change in depreciation expense		6.0%	6.0%		3.0%	0.2%
% change in accounts receivable		6.0%	6.0%		2.0%	22.3%
% change in inventories		5.0%	13.8%		0.0%	(13.5%)
Revenues % cash collections	1.03	1.03	1.03	1.0	1.0	1.1
Days inventory outstanding	155	153	164	144	143	106
Balance sheet accrual ratio	3.4%	3.5%	3.9%	2.0%	2.4%	10.1%
Cash flow accrual ratio	3.4%	3.5%	3.8%	2.0%	2.0%	4.3%

The quality of earnings as measured by balance-sheet-based accruals ratios showed:

A) decrease in Jefferson's earnings quality relative to Adams's due to the sharp jump in the ratio in 2008 compared to a much smaller increase for Adams.

B) both companies' earnings quality improved due to the increase in the ratio with Jefferson showing the most improvement.

C) strong improvement in Jefferson's earnings quality relative to Adams's due to the sharp jump in the ratio in 2008 compared to the much smaller increase for

Explanation

The lower the ratio, the higher will be the earnings quality. Jefferson's ratio rose sharply in 2008 compared to the previous years and was substantially above Adams's. Thus, Jefferson's earnings quality is lower.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #25 of 63

Question ID: 1209142

Which of the following statements about operating income and operating cash flow is *most* accurate?

A) Operating income is more reliable than operating cash flow because of the judgments and estimates involved with accrual accounting.

B) Operating cash flow usually increases faster than operating income when the firm is growing.

C) Operating income is confirmed by operating cash flow when the growth rates of the two measures are relatively stable over time.

Explanation

When the growth rates of operating income and operating cash flow are stable over time, operating income is being confirmed by operating cash flow. Operating cash flow is more reliable than operating income. During growth, operating cash flow is usually lower than operating income as the firm uses cash to increase inventories and receivables.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #26 of 63

Question ID: 1209165

Classification shifting is *least likely* to result in a higher:

A) equity value derived when earnings forecasts are based on operating earnings.

B) firm value derived when cash flow forecasts are based on core earnings.

C) reported net income.

Explanation

Classification shifting results in inflation of core or recurring earnings while keeping the total reported income same. This is used to mislead analysts into using a higher number as a basis for generating forecasts of future earnings and cash flows. Such erroneous forecasts would then result in inflated equity and firm valuation.

(Study Session 6, Module 17.2, LOS 17.f)

Related Material

SchweserNotes - Book 2

Question #27 of 63

Question ID: 1209131

Fero Inc. (Fero) is a successful computer consulting services firm that has an established policy of investing its excess cash in short-term, virtually riskless, and highly liquid money market securities. However, it has recently deviated from this policy by investing in commercial paper and medium-cap domestic equities. As well, Fero entered into a $1.0 million lease with Pasquale Inc. (Pasquale) for some specialized computer equipment on December 28, 2008 that will be shipped at the very start of its next fiscal period on January 1, 2009. In exchange for the lease, Fero agrees to provide consulting services to Pasquale. Which of the following activities is one in which Fero is *least* likely involved?

A) Ignoring cash flow.

B) Managing cash flow.

C) Misclassifying cash flow.

Explanation

Fero is ignoring cash flow, most likely misclassifying cash flow, but there is no evidence that Fero is managing cash flow. Firms can misrepresent their cash generating ability by misclassifying investing activities as operating activities and vice versa. For example, under U.S. GAAP, the cash flow statement reconciles the changes in cash and cash equivalents. Cash equivalents include short-term, highly liquid investments. Some firms park cash in longer-term investments such as marketable debt and equity securities. Typically, the acquisition and disposal cash flows from these longer-term investments are reported as investing activities in the cash flow statement.

Noncash investing and financing activities are not reported in the cash flow statement since they do not result in an inflow or outflow of cash. For example, a capital lease is both an investing and financing decision in that the transaction is the equivalent of borrowing the purchase price. However, since no cash is involved, the transaction is not reported (it is *ignored*) on the cash flow statement throughout the life of the lease.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #28 of 63

Question ID: 1209164

High Plains Tubular Company is a leading manufacturer and distributor of quality steel products used in energy, industrial, and automotive applications worldwide.

The U.S. steel industry has been challenged by competition from foreign producers located primarily in Asia. All of the U.S. producers are experiencing declining margins as labor costs continue to increase. In addition, the U.S. steel mills are technologically inferior to the foreign competitors. Also, the U.S. producers have significant environmental issues that remain unresolved.

High Plains is not immune from the problems of the industry and is currently in technical default under its bond covenants. The default is a result of the failure to meet certain coverage and turnover ratios. Earlier this year, High Plains and its bondholders entered into an agreement that will allow High Plains time to become compliant with the covenants. If High Plains is not in compliance by year end, the bondholders can immediately accelerate the maturity date of the bonds. In this case, High Plains would have no choice but to file bankruptcy.

High Plains follows U.S. GAAP. For the year ended 2008, High Plains received an unqualified opinion from its independent auditor. However, the auditor's opinion included an explanatory paragraph about High Plains' inability to continue as a going concern in the event its bonds remain in technical default.

At the end of 2008, High Plains' Chief Executive Officer (CEO) and Chief Financial Officer (CFO) filed the necessary certifications required by the Securities and Exchange Commission (SEC).

To get a better understanding of High Plains' financial situation, it is helpful to review High Plains' cash flow statement found in Exhibit 1 and selected financial footnotes found in Exhibit 2.

Exhibit 1: Cash Flow Statement

High Plains Tubular Cash Flow Statement

	Year ended December 31,	
in thousands	**2008**	**2007**
Net income	$158,177	$121,164
Depreciation expense	34,078	31,295
Deferred taxes	7,697	11,407
Receivables	(144,087)	(24,852)
Inventory	(79,710)	(72,777)
Payables	36,107	22,455

Cash flow from operations	$12,262	$88,692
Cash flow from investing	($39,884)	($63,953)
Cash flow from financing	$82,676	$6,056
Change in cash	$55,054	$30,795

Exhibit 2: Selected Financial Footnotes

1. During 2008, High Plains' sales increased 27% over 2007. Its sales growth continues to significantly exceed the industry average. Sales are recognized when a firm order is received from the customer, the sales price is fixed and determinable, and collectability is reasonably assured.
2. The cost of inventories is determined using the last-in, first-out (LIFO) method. Had the first-in, first-out method been used, inventories would have been $152 million and $143 million higher as of December 31, 2008 and 2007, respectively.
3. Effective January 1, 2008, High Plains changed its depreciation method from the double-declining balance method to the straight-line method in order to be more comparable with the accounting practices of other firms within its industry. The change was not retroactively applied and only affects assets that were acquired on or after January 1, 2008.
4. High Plains made the following discretionary expenditures for maintenance and repair of plant and equipment and for advertising and marketing:

in millions	2008	2007	2006
Maintenance and repairs	$180	$184	$218
Advertising and marketing	94	108	150

5. During the fiscal year ended December 31, 2008, High Plains sold $50 million of its accounts receivable, with recourse, to an unrelated entity. All of the receivables were still outstanding at year end.
6. High Plains conducts some of its operations in facilities leased under noncancelable finance (capital) leases. Certain leases include renewal options with provisions for increased lease payments during the renewal term.
7. High Plains' average net operating assets at the end of 2008 and 2007 was $977.89 million and $642.83 million, respectively.

Which of the following statements about evaluating High Plains' financial reporting quality is *least* accurate?

A) Higher Plains may have manipulated earnings due to the risk of default.

B) High Plains’ extreme revenue growth will likely revert back to normal levels over time.

C) Because of the estimates involved, a higher weighting should be assigned to the accrual component of High Plains' earnings as compared to the cash component.

Explanation

It appears that High Plains manipulated its earnings upward in 2008 to avoid default under its bond covenants. However, the higher earnings are lower quality as measured by the cash flow accrual ratio. Because of the estimates involved, a *lower* weighting should be assigned to the accrual component of High Plains' earnings. Extreme earnings (including revenues) tend to revert to normal levels over time (mean reversion).

(Study Session 6, Module 17.2, LOS 17.e)

Related Material

SchweserNotes - Book 2

Question #29 of 63

Question ID: 1209160

Jeremy Jennings is explaining the concept of earnings quality to his new colleagues. Which of the following measures is *most* indicative of a higher quality of earnings when attempting to forecast future earnings?

A) Higher level of earnings.

B) Higher degree of conservatism of earnings.

C) Higher degree of persistence of earnings.

Explanation

The term earnings quality usually refers to the persistence and sustainability of a firm's earnings; that is, more persistent and sustainable earnings are considered higher quality.

Measuring earnings quality based on conservative earnings is an inferior measure when attempting to forecast future earnings because most accruals will self-correct over time. For example, the lower earnings that result from accelerated depreciation will increase in the later years of the asset's life. Focusing on accruals and deferrals is a more effective way of measuring earnings quality.

A higher level of earnings has no impact on increasing the quality of earnings since the former may be derived largely from earnings manipulation on the part of management.

(Study Session 6, Module 17.2, LOS 17.e)

Related Material

SchweserNotes - Book 2

Question #30 of 63

Question ID: 1209171

Mean reversion in earnings means that:

A) Extreme high as well as low levels of earnings will revert to the mean.

B) Extreme high earnings will revert to the mean but extreme low earnings will not.

C) Extreme low earnings will revert to the mean but extreme high earnings will not.

Explanation

Mean reversion in earnings means that extreme high or low earnings are not sustainable and will mean revert.

(Study Session 6, Module 17.3, LOS 17.g)

Related Material

SchweserNotes - Book 2

Question #31 of 63

Question ID: 1209125

Which of the following choices is *most likely* a biased accounting choice to overstate profitability?

A) Lessor use of sales-type finance lease classification.

B) Classifying non-operating expenses as operating.

C) Channeling gains through OCI and losses through income statement.

Explanation

Lessor use of sales-type finance lease classification results in Lessor recognizing the gross profit at inception of the lease and is a mechanism to overstate profitability. Classifying non-operating expenses as operating and channeling gains through OCI and losses through income statement would understate profitability.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #32 of 63

Question ID: 1209133

The failure to recognize inventory obsolescence is an example of __________.

A) Understating expenses.

B) Delaying expenses.

C) Misclassifying expenses.

Explanation

Inventory must be tested for obsolescence using the lower-of-cost-or-market method. Obsolete inventory must be written down (expensed) in the income statement which results in lower earnings. Thus, failure to recognize obsolescence understates expenses and overstates earnings.

Delaying expenses involves deferring recognition to a future period. Delaying expense is the result of capitalizing a cost instead of immediately recognizing the cost in the income statement. This is not the same as failing to recognize inventory obsolescence.

Investors typically focus more on operating income than nonrecurring and non-operating income. Thus, firms may have an incentive to increase operating income by misclassifying an operating expense as a nonrecurring or non-operating item. Therefore, failure to recognize obsolescence is not an example of misclassification.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #33 of 63

Question ID: 1209126

Aggressive revenue recognition practices are *least likely* to increase:

A) reported expenses

B) reported assets

C) reported ending inventory

Explanation

Aggressive revenue recognition practices would increase accounts receivable, revenues, expenses, income and stockholder's equity. Ending inventory would decline but by less than the increase in accounts receivable resulting in increase in total assets. Early recognition of revenues also accelerates recognition of expenses (COGS).

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #34 of 63

Question ID: 1209163

Which of the following statements about financial disclosures are correct or incorrect?

Statement #1:	Transitory earnings are usually more important to investors than permanent earnings.
Statement #2:	Pro-forma earnings are usually prepared in accordance with generally accepted accounting principles.

A) Both are incorrect. ✓

B) Only statement #2 is incorrect. ✗

C) Only statement #1 is incorrect. ✗

Explanation

Statement #1 is incorrect. Investors are usually more interested in permanent earnings. Statement #2 is incorrect. Pro-forma earnings are not prepared in accordance with generally accepted accounting principles because they may exclude certain transactions. This is why it is important for an analyst to understand the disclosures.

(Study Session 6, Module 17.2, LOS 17.e)

Related Material

SchweserNotes - Book 2

Question #35 of 63

Question ID: 1209162

A manufacturing firm purchases equipment for use in its operations. With regard to recording the purchase using the cash basis versus the accrual basis of accounting, which of the following statements is *most* appropriate?

A) With the cash basis, revenues and expenses relating to the equipment are generally recognized in different periods. ✓

B) With the accrual basis, the cost of the equipment is allocated to the cash flow statements over the asset's life. ✗

C) With the cash basis, revenues and expenses relating to the equipment are generally recognized in the same period. ✗

Explanation

With the *cash basis* of accounting, revenues are recognized when cash is collected and expenses are recognized when cash is paid. Therefore, the cash flows may occur in different periods than when the revenues are actually earned or when the expenses are actually incurred. For example, the purchase of equipment used in a firm's manufacturing operation may result in an immediate cash outflow but the equipment generates revenues over its useful life. In this case, the revenues and expense are reported in different periods.

With the *accrual basis* of accounting, revenues are recognized when earned and expenses are recognized when incurred, regardless of the timing of the cash flows. With the equipment purchase, the cost of the equipment will be allocated to the income statement (not cash flow statement) over the asset's life and at the same time, matched with the revenues generated.

(Study Session 6, Module 17.2, LOS 17.e)

Related Material

SchweserNotes - Book 2

Hatfield Industries is a large manufacturing conglomerate based in the United States with annual sales in excess of $300 million. Its shares are traded on the New York Stock Exchange, and have a market capitalization of nearly $750 million. Hatfield is currently under investigation by the Securities and Exchange Commission (SEC) for accounting irregularities and possible legal violations in the presentation of the company's financial statements. A due diligence team from the SEC has been sent to Hatfield's corporate headquarters in Philadelphia for a complete audit in order to further assess the situation.

Several unique circumstances at Hatfield are discovered by the SEC due diligence team during the course of the investigation:

Management has been involved in ongoing negotiations with the local labor union, of which approximately 40% of its full-time labor force are members. Labor officials are seeking increased wages and pension benefits, both of which Hatfield's management states is not possible at this time due to decreased profitability and a tight cash flow situation. Labor officials have accused Hatfield's management of manipulating the company's financial statements in order to have a reason to not grant any concessions during the course of negotiations.

All new equipment obtained over the past several years has been established on Hatfield's books as operating leases, although past acquisitions of similar equipment was nearly always classified as capital leases. Financial statements of industry peers indicate that capital leases for this type of equipment are the norm. The SEC wants Hatfield's management to provide justification for this apparent deviation from "normal" accounting practices.

Inventory on Hatfield's books has been steadily increasing for the past few years in comparison to sales growth. Management credits improved operating efficiencies in its production methods that have contributed to boosts in overall production. The SEC is seeking evidence that Hatfield somehow may have manipulated its inventory accounts.

The SEC due diligence team is not necessarily searching for evidence of fraud, but possible manipulation of accounting standards for the purpose of misleading shareholders and other interested parties. Initial review of Hatfield's financial statements indicates that at a minimum, certain practices have resulted in low quality earnings.

Question #36 - 40 of 63

Question ID: 1209149

Labor officials believe that the management of Hatfield is attempting to understate its net income in order to avoid making any concessions in the labor negotiations. Which of the following actions is *least likely* to be employed by management in an attempt to avoid making concessions to the union?

A) Lowering the discount rate used in the valuation of the company's pension obligations. ✗

B) Lengthening the life of depreciable assets in order to lower the depreciation expense. ✓

C) Recognizing revenue at the time of delivery rather than when payment is received. ✗

Explanation

It is unlikely that management would lengthen the life of depreciable assets in order to extract concessions from the union, as lengthening the depreciable life of an asset would boost earnings results.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #37 - 40 of 63

Question ID: 1209150

Hatfield has begun recording all new equipment leases on its books as operating leases, a change from its consistent past use of capital leases. What is the *most likely* motivation behind Hatfield's change in accounting methodology? Hatfield is attempting to:

A) increase its operating margins relative to industry peers. ✗

B) reduce its cost of goods sold and increase it profitability.

C) improve its leverage ratios and reduce its perceived leverage.

Explanation

Off balance-sheet financing through the use of operating leases is acceptable when used appropriately. However, companies can use them too aggressively in order to reduce their perceived leverage. A comparison among industry peers and their practices may indicate improper use of accounting methods.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #38 - 40 of 63

Question ID: 1209151

The SEC due diligence team is searching for the reason behind Hatfield's inventory build-up relative to its sales growth. One way to identify a deliberate manipulation of financial results by Hatfield is to search for:

A) a delay in the recognition of expenses.

B) receivables that are growing faster than sales.

C) a decline in inventory turnover.

Explanation

A warning sign of accounting manipulation is abnormal inventory growth as compared to sales growth. By overstating inventory, the cost of goods sold is lower, leading to higher profitability.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #39 - 40 of 63

Question ID: 1209152

Which of the following findings is *most likely* to be an indicator of potential revenue quality issues?

A) Large increases in trade receivables.

B) Reduction in volatility of the ratio of revenue to cash collection.

C) Lessor use of the operating lease classification.

Explanation

Revenue quality issues may be indicated by large increases in accounts receivable or large decreases in unearned revenue, an *increase* in the volatility of the ratio of revenue to cash collections, and by lessor use of capital leases.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #40 - 40 of 63

Question ID: 1209153

Which of the following is *least likely* to be an indicator of improper accounting to boost operating performance?

A) Deferral of expenses by capitalizing.

B) Decreases in core operating margin accompanied by spikes in negative special items.

C) Classification of ordinary expenses as nonrecurring.

Explanation

Classification of ordinary expenses as nonrecurring and deferral of expenses via capitalization would improve reported operating margins as would increases in core operating margin accompanied by spikes in negative special items.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #41 of 63

Question ID: 1209182

High Plains Tubular Company is a leading manufacturer and distributor of quality steel products used in energy, industrial, and automotive applications worldwide.

The U.S. steel industry has been challenged by competition from foreign producers located primarily in Asia. All of the U.S. producers are experiencing declining margins as labor costs continue to increase. In addition, the U.S. steel mills are technologically inferior to the foreign competitors. Also, the U.S. producers have significant environmental issues that remain unresolved.

High Plains is not immune from the problems of the industry and is currently in technical default under its bond covenants. The default is a result of the failure to meet certain coverage and turnover ratios. Earlier this year, High Plains and its bondholders entered into an agreement that will allow High Plains time to become compliant with the covenants. If High Plains is not in compliance by year end, the bondholders can immediately accelerate the maturity date of the bonds. In this case, High Plains would have no choice but to file bankruptcy.

High Plains follows U.S. GAAP. For the year ended 2008, High Plains received an unqualified opinion from its independent auditor. However, the auditor's opinion included an explanatory paragraph about High Plains' inability to continue as a going concern in the event its bonds remain in technical default.

At the end of 2008, High Plains' Chief Executive Officer (CEO) and Chief Financial Officer (CFO) filed the necessary certifications required by the Securities and Exchange Commission (SEC).

To get a better understanding of High Plains' financial situation, it is helpful to review High Plains' cash flow statement found in Exhibit 1 and selected financial footnotes found in Exhibit 2.

Exhibit 1: Cash Flow Statement

High Plains Tubular Cash Flow Statement

	Year ended December 31,	
in thousands	**2008**	**2007**
Net income	$158,177	$121,164
Depreciation expense	34,078	31,295
Deferred taxes	7,697	11,407
Receivables	(144,087)	(24,852)
Inventory	(79,710)	(72,777)
Payables	36,107	22,455

Cash flow from operations	$12,262	$88,692
Cash flow from investing	($39,884)	($63,953)
Cash flow from financing	$82,676	$6,056
Change in cash	$55,054	$30,795

Exhibit 2: Selected Financial Footnotes

1. During 2008, High Plains' sales increased 27% over 2007. Its sales growth continues to significantly exceed the industry average. Sales are recognized when a firm order is received from the customer, the sales price is fixed and determinable, and collectability is reasonably assured.
2. The cost of inventories is determined using the last-in, first-out (LIFO) method. Had the first-in, first-out method been used, inventories would have been $152 million and $143 million higher as of December 31, 2008 and 2007, respectively.
3. Effective January 1, 2008, High Plains changed its depreciation method from the double-declining balance method to the straight-line method in order to be more comparable with the accounting practices of other firms within its industry. The change was not retroactively applied and only affects assets that were acquired on or after January 1, 2008.
4. High Plains made the following discretionary expenditures for maintenance and repair of plant and equipment and for advertising and marketing:

in millions	2008	2007	2006
Maintenance and repairs	$180	$184	$218
Advertising and marketing	94	108	150

5. During the fiscal year ended December 31, 2008, High Plains sold $50 million of its accounts receivable, with recourse, to an unrelated entity. All of the receivables were still outstanding at year end.
6. High Plains conducts some of its operations in facilities leased under noncancelable finance (capital) leases. Certain leases include renewal options with provisions for increased lease payments during the renewal term.
7. High Plains' average net operating assets at the end of 2008 and 2007 was $977.89 million and $642.83 million, respectively.

As compared to the year ended 2007, High Plains' cash flow accrual ratio for the year ended 2008 is:

A) the same.

B) higher.

C) lower.

Explanation

The cash flow accrual ratio increased during 2008 from 15% to 19%.

in thousands	**2008**	**2007**
Net income	$158,177	$121,164
− Cash from operations	12,262	88,692
− Cash from investing	(39,884)	(63,953)
= Accruals	$185,799	$96,425
÷ Net operating assets	$977,890	$642,830
= Cash flow accrual ratio	19%	15%

(Study Session 6, Module 18.5, LOS 18.e)

Related Material

SchweserNotes - Book 2

Question #42 of 63

Question ID: 1209135

De Freitas Inc. (De Freitas) is a conglomerate. Its computer division was very profitable in the current year because it launched a successful new lightweight laptop computer. Prices in the automobile division have been rising over the years but it is engaged in a LIFO liquidation in the current year. Which of the following best describes the effect on the long-run earnings of the computer division and the automobile division compared to the most recent year?

	Computer division earnings	Automobile division earnings
A)	Decrease	Decrease
B)	Increase	Decrease
C)	Decrease	Increase

Explanation

When examining earnings, analysts should be aware that earnings at extreme levels tend to revert back to normal levels over time. This phenomenon is known as mean reversion. For example, capital is attracted to successful projects (i.e. the new laptop) thereby increasing competition and *decreasing* earnings in the long-run.

A LIFO liquidation involves selling more goods than are replaced. Thus, the automobile division penetrated the older, lower cost layers of inventory thereby increasing profit. This higher profitability is not sustainable, however, because the firm will eventually run out of lower priced inventory. In the long-run, the earnings will *decrease* (to normal levels).

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #43 of 63

Question ID: 1209130

Which of the following statements about cash flow is (are) CORRECT?

Statement #1:	The cash effects of decreasing accounts payable turnover are unlimited.
Statement #2:	The tax benefits from employee stock options can result in a significant source of investing cash flow.

	Statement #1	Statement #2	
A)	Incorrect	Incorrect	✓
B)	Incorrect	Correct	✗
C)	Correct	Incorrect	✗

Explanation

Statement #1 is an incorrect statement. The cash effects of decreasing accounts payable turnover are limited. Suppliers will eventually stop extending credit because of delayed payments. Statement #2 is an incorrect statement. The tax benefits from employee stock options can result in a significant source of operating and financing cash flows. Tax benefits do not affect *investing* cash flows.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #44 of 63

Question ID: 1209185

Asma Pharma has made several strategic investments in other pharmaceutical companies. In each instance, Asma has kept its stake just below 50% so it can account for the investment using the equity method of consolidation.

Asma's balance sheet quality can be *most accurately* characterized as:

A) Low-quality due to lack of completeness.

B) High-quality due to compliance with local GAAP.

C) Low-quality due to bias in measurement.

Explanation

One-line consolidation under the equity method obscures the components of balance sheet and artificially boosts certain profitability ratios (e.g., return on assets or profit margin). This reduces the completeness and quality of the firm's balance sheet. Compliance with GAAP is a necessary but not sufficient condition for evaluating quality of financial statements. Equity method of accounting does not by itself lead to measurement bias.

(Study Session 6, Module 17.5, LOS 17.l)

Related Material

SchweserNotes - Book 2

Question #45 of 63

Question ID: 1209124

To assess the quality of financial reports, which question is *least* necessary for an analyst to answer?

A) Are reported earnings consistent with the firm's budget?

B) Do earnings represent an adequate level of return?

C) Are the financial reports decision useful and GAAP compliant?

Explanation

Quality of financial reports is assessed by answering two questions: Whether the financial reports are decision useful and GAAP compliant and whether the results quality is high (i.e., earnings provide adequate return on capital and are sustainable).

(Study Session 6, Module 17.1, LOS 17.a)

Related Material

SchweserNotes - Book 2

Question #46 of 63

Question ID: 1209161

Classification of non-operating income as operating would lead to stated earnings that are likely to be:

A) non-compliant with GAAP.

B) compliant with GAAP but not sustainable.

C) compliant with GAAP and sustainable.

Explanation

Non-operating income is less likely to recur and hence the earnings that include such misclassified non-operating income would be considered non-sustainable. The misclassification need not always be GAAP non-compliant.

(Study Session 6, Module 17.2, LOS 17.e)

Related Material

SchweserNotes - Book 2

Question #47 of 63

Question ID: 1209166

Which one of the following choices is *least likely* to be an indicator of poor-quality earnings?

A) An investigation by the market regulatory authority is initiated.

B) Reported earnings handily beat analyst estimates.

C) Restatement of previously issued financial statements.

Explanation

Enforcement actions by regulatory authorities and restatements of previously issued financial statements are two (external) indicators of poor-quality earnings. Earnings that meet or narrowly beat analyst estimates are considered to be suspect for poor quality. Handily beating analyst estimates is not considered to be an indicator of poor-quality earnings.

(Study Session 6, Module 17.2, LOS 17.f)

Related Material

SchweserNotes - Book 2

Question #48 of 63

Question ID: 1209134

Charles Nicholls, chief investment officer of Gertmann Money Management, is reviewing the year-end financial statements of Zartner Canneries. In those statements he sees a sharp increase in inventories well above the sales-growth rate, and an increase in the discount rate for its pension liabilities. To determine whether or not Zartner Canneries is cooking the books, what should Nicholls do?

A) Check Zartner's cash-flow statement and review its footnotes. ✗

B) Calculate Zartner's turnover ratios and review the footnotes of its competitors. ✓

C) Analyze trends in Zartner's receivables and consider the changing characteristics of its work force. ✗

Explanation

To assess the meaning of the inventory increase, look for declines in inventory turnover. And if Zartner changes its pension assumptions, Nicholls should see how those new assumptions compare to those found in the footnotes of financial statements from other companies in the same industry.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #49 of 63

Question ID: 1209132

Joe Carter, CFA, believes Triangle Equipment, a maker of large, specialized industrial equipment, has overstated the salvage value of its equipment. This would:

A) understate earnings. ✗

B) overstate earnings. ✓

C) overstate liabilities. ✗

Explanation

Overstating the salvage value reduces depreciation expense, which in turn increases earnings.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #50 of 63

Question ID: 1209183

Which of the following is *least likely* an indicator of biased measurement in assessing balance sheet quality?

A) Understatement of inventory impairment charges.

B) Presence of substantial goodwill on balance sheet.

C) Understatement of valuation allowance for deferred tax assets.

Explanation

Presence of substantial goodwill does not inherently make it biased measurement. Only if the value of goodwill is unjustified (based on market values of the investments), would the measurement be considered biased. Understatement of inventory impairment charges overstates value of inventory. Similarly understatement of valuation allowance for deferred tax assets overstates the value of deferred tax assets.

(Study Session 6, Module 17.5, LOS 17.k)

Related Material

SchweserNotes - Book 2

Question #51 of 63

Question ID: 1209168

Complete the following sentence. When earnings are relatively free of accruals, mean reversion will occur _________.

A) relatively faster than usual.

B) at the same rate as usual.

C) relatively slower than usual.

Explanation

Earnings consist of cash flow and accruals and there is an inverse relationship between accruals and cash flow. When earnings are relatively free of accruals, mean reversion will occur at a slower rate. The opposite is true when earnings are largely comprised of accruals.

(Study Session 6, Module 17.3, LOS 17.g)

Related Material

SchweserNotes - Book 2

Question #52 of 63

Question ID: 1209129

Marcel Schulte is analyzing various retailing firms. Which of the following items is *least* indicative of a potential problem with revenue recognition and earnings quality?

A) Implementing a “bill and hold” arrangement.

B) Use of barter transactions.

C) Disproportionate revenues in the last quarter of the calendar year.

Explanation

Disproportionate revenues in the last quarter may be an indication of aggressive revenue recognition to meet analyst forecasts but it is much more likely if the firm is a *non-seasonal* one. A retailing firm presumably has a disproportionate amount of sales during the busy Christmas season in the last quarter of the calendar year so this point alone would not be indicative of a potential problem.

In a barter transaction, two parties exchange goods or services. The main issue is whether: (a) a sale transaction has actually occurred in substance; (b) it is not a "sham" transaction; and (c) the transaction amount is overstated.

Bill and hold occurs when the retailer (seller) invoices the customer but does not ship the goods until a later date. Alternatively, the seller may ship the goods to a location other than the customer's. In either case, the seller may be recognizing revenue prematurely.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #53 of 63

Question ID: 1209170

Sustainable earnings are most likely to be driven by:

A) Conservative revenue recognition practices.

B) Accruals element of earnings.

C) Cash flow element of earnings.

Explanation

Sustainable and persistent earnings are driven by cash flow element of earnings. The stability and accuracy of earnings forecasts can be reduced by estimation process that generates the accruals component of earnings. Conservative and aggressive revenue recognition practices both would result in reversion in earnings (and hence lowers the sustainability of earnings).

(Study Session 6, Module 17.3, LOS 17.g)

Related Material

SchweserNotes - Book 2

Question #54 of 63

Question ID: 1209156

Brent Jones, CFA is analyzing the financial statements of Imperial Resorts Inc. Jones wants to use the Beneish model to evaluate the probability of earnings manipulation.

Jones makes the following statements:

1. Depreciation index of less than 1 would indicate that the company is depreciating assets at a higher rate than its peers.
2. Increases in Asset quality index indicate that the revenue recognition policies are conservative.

Regarding the statements by Jones:

A) Only statement 2 is correct.

B) None of the statements is correct.

C) Only statement 1 is correct.

Explanation

Statement 1 is incorrect. Depreciation index less than 1 indicates that the company is depreciating assets at a higher rate than in prior years (and not relative to its peers). Statement 2 is incorrect. Asset quality index is used as an indicator of excessive capitalization of expenses.

(Study Session 6, Module 17.2, LOS 17.d)

Related Material

SchweserNotes - Book 2

Question #55 of 63

Question ID: 1209172

Andre Bursh, is analyzing large retailers and has collected the following information on three companies based on the most recent financial statements:

	Allied Stores	**Beta Mart**	**Cash-N-Carry**
Total Earnings (per share)	$2.80	$1.33	$0.75
Cash element	$1.90	$0.78	$0.25
Accrual element	$0.90	$0.55	$0.50

Bursh notes that all three companies have reported stellar earnings this past year. Bursh is concerned about sustainability of such high earnings. Which company's earnings will revert to its mean fastest?

A) Cash-N-Carry.

B) Beta Mart.

C) Allied Stores.

Explanation

Cash-N-Carry's earnings is comprised of large proportion of accruals (0.50/0.75 or 67%). Allied's accruals comprise (0.90/2.80) 32% of earnings and Beta's accruals comprise 41% of earnings.

(Study Session 6, Module 17.3, LOS 17.g)

Related Material

SchweserNotes - Book 2

Question #56 of 63

Question ID: 1209143

High Plains Tubular Company is a leading manufacturer and distributor of quality steel products used in energy, industrial, and automotive applications worldwide.

The U.S. steel industry has been challenged by competition from foreign producers located primarily in Asia. All of the U.S. producers are experiencing declining margins as labor costs continue to increase. In addition, the U.S. steel mills are technologically inferior to the foreign competitors. Also, the U.S. producers have significant environmental issues that remain unresolved.

High Plains is not immune from the problems of the industry and is currently in technical default under its bond covenants. The default is a result of the failure to meet certain coverage and turnover ratios. Earlier this year, High Plains and its bondholders entered into an agreement that will allow High Plains time to become compliant with the covenants. If High Plains is not in compliance by year end, the bondholders can immediately accelerate the maturity date of the bonds. In this case, High Plains would have no choice but to file bankruptcy.

High Plains follows U.S. GAAP. For the year ended 2008, High Plains received an unqualified opinion from its independent auditor. However, the auditor's opinion included an explanatory paragraph about High Plains' inability to continue as a going concern in the event its bonds remain in technical default.

At the end of 2008, High Plains' Chief Executive Officer (CEO) and Chief Financial Officer (CFO) filed the necessary certifications required by the Securities and Exchange Commission (SEC).

To get a better understanding of High Plains' financial situation, it is helpful to review High Plains' cash flow statement found in Exhibit 1 and selected financial footnotes found in Exhibit 2.

Exhibit 1: Cash Flow Statement

High Plains Tubular Cash Flow Statement

	Year ended December 31,	
in thousands	**2008**	**2007**
Net income	$158,177	$121,164
Depreciation expense	34,078	31,295
Deferred taxes	7,697	11,407
Receivables	(144,087)	(24,852)
Inventory	(79,710)	(72,777)
Payables	36,107	22,455

Cash flow from operations	$12,262	$88,692
Cash flow from investing	($39,884)	($63,953)
Cash flow from financing	$82,676	$6,056
Change in cash	$55,054	$30,795

Exhibit 2: Selected Financial Footnotes

1. During 2008, High Plains' sales increased 27% over 2007. Its sales growth continues to significantly exceed the industry average. Sales are recognized when a firm order is received from the customer, the sales price is fixed and determinable, and collectability is reasonably assured.
2. The cost of inventories is determined using the last-in, first-out (LIFO) method. Had the first-in, first-out method been used, inventories would have been $152 million and $143 million higher as of December 31, 2008 and 2007, respectively.
3. Effective January 1, 2008, High Plains changed its depreciation method from the double-declining balance method to the straight-line method in order to be more comparable with the accounting practices of other firms within its industry. The change was not retroactively applied and only affects assets that were acquired on or after January 1, 2008.
4. High Plains made the following discretionary expenditures for maintenance and repair of plant and equipment and for advertising and marketing:

in millions	2008	2007	2006
Maintenance and repairs	$180	$184	$218
Advertising and marketing	94	108	150

5. During the fiscal year ended December 31, 2008, High Plains sold $50 million of its accounts receivable, with recourse, to an unrelated entity. All of the receivables were still outstanding at year end.
6. High Plains conducts some of its operations in facilities leased under noncancelable finance (capital) leases. Certain leases include renewal options with provisions for increased lease payments during the renewal term.
7. High Plains' average net operating assets at the end of 2008 and 2007 was $977.89 million and $642.83 million, respectively.

What is the *most likely* effect of High Plains' revenue recognition policy on net income and inventory turnover?

A) Net income and inventory turnover are overstated.

B) Only inventory turnover is overstated.

C) Only net income is overstated.

Explanation

Revenue should be recognized when earned and payment is assured. High Plains is recognizing revenue as orders are received. Since High Plains still has an obligation to deliver the goods, revenue is not yet earned. By recognizing revenue too soon, net income is overstated and ending inventory is understated. Understated ending inventory would result in an overstated inventory turnover ratio.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #57 of 63

Question ID: 1209167

Hartford Manufacturing Case Scenario

Sally Wellington, CFA, analyzes the financial statements of Hartford Manufacturing, a company located in the United States that uses U.S. GAAP. Wellington determines that Hartford's most significant assets are its inventory and long-term assets. Wellington is interested in the financial statement and ratio impact of the accounting methods used by Hartford to account for these assets, especially when compared to the methods used by Hartford's competitors. She gathers the following information to aid in her analysis:

Exhibit 1	
Selected Financial Information (US$ millions)	
Year Ended December 31, 20X1	
Select Balance Sheet Information	
Inventory	16,253
Property, plant and equipment, gross	34,221
Accumulated depreciation	(12,835)
Property, plant and equipment, net	21,836
Total assets	60,038
Total liabilities	40,736
Total equity	19,302
Income Statement Information	
Revenues	32,396
Cost of goods sold	18,885
Lease expense	590
Other expense	5,911
Depreciation expense	2,336
EBIT	4,674
Interest expense	1,522
Income tax expense (30%)	946
Net income	2,206

Based on her knowledge of Hartford's competitors and her review of Hartford's financial statement disclosures and Management's Discussion and Analysis (MD&A), Wellington notes the following:

Hartford accounts for its inventory using the LIFO method. All of Hartford's competitors use the FIFO method.

As a result of technological advancements, the cost to produce Hartford's inventory has fallen each year for the last five years. Hartford's LIFO reserve was (–)$2,603 in 20X0 and (–)$3,183 in 20X1.

Hartford recorded a $520 fixed-asset impairment loss on its December 31, 20X0 income statement. Wellington concluded that this impairment loss increased Hartford's fixed-asset turnover ratio in 20X0, and Hartford's return on assets and net profit margin in 20X1.

In 20X1 Hartford changed its depreciation method from the straight-line method to the double-declining balance method and increased the useful lives and salvage values of its fixed assets.

The majority of Hartford's lease agreements are accounted for as operating leases. Hartford's largest competitors account for the majority of their leases as capital (finance) leases.

Wellington knows that the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) have proposed a change in lease accounting that would require the capitalization of all leases, including leases currently classified as operating leases. Using a discount rate of 8% and an average remaining lease term of five years, Wellington determines that the present value of Hartford's operating leases was $2,630 on December 31, 20X1.

Which of the following characteristics of Hartford's long-term asset accounting is *least likely* to be considered a quality of financial reporting problem by Wellington?

A) The change from straight-line to double-declining balance depreciation. ✓

B) The increase in the useful lives and salvage values of Hartford's fixed assets. ✗

C) The classification of the majority of Hartford's leases as operating leases. ✗

Explanation

Double-declining balance (DDB) depreciation is a more conservative method of depreciation than straight-line because more depreciation expense is reported in the early years under DDB. Therefore, Wellington is not likely to consider Hartford's change from straight-line to double-declining balance depreciation to be a quality of financial reporting problem.

Operating leases are a form of off-balance sheet financing that result in an understatement of an entity's liabilities. Wellington will likely consider Hartford's extensive use of operating leases to be a quality of financial reporting problem, especially given that Hartford's largest competitors account for the majority of their leases as capital (finance) leases.

The increase in the useful lives and salvage values of Hartford's fixed assets is likely to be considered a quality of financial reporting problem by Wellington because longer useful lives and higher salvage values decrease (understate) depreciation expense. An effort to reduce expense could be a sign that the firm is trying to hide other problems, such as deteriorating core profitability.

(Study Session 6, Module 17.2, LOS 17.f)

Related Material

SchweserNotes - Book 2

Question #58 of 63

Question ID: 1209173

Pysha Heavy Metals Ltd. supplies specialized metals to the chip fabrication industry.

Selected financial data for Pysha, as well as industry comparables, are shown below:

Pysha selected financial data (£ '000s):

	20x7	***20x8***	***20x9***
Sales	1,169	1,312	1,414
Accounts receivable	58.45	72.16	98.98

Industry average:

	20x7	***20x8***	***20x9***
DSO	22.6	22.8	22.4
Receivables turnover	16.2	16.0	16.3

Based on the trend in revenues and receivables, it can be *most accurately* concluded that:

A) The revenue growth rate divided by receivables growth rate is increasing over time.

B) Pysha’s revenues are growing at a faster rate than its receivables.

C) Pysha’s revenues are growing at a slower rate than its receivables

Explanation

Pysha's revenue growth rate is lagging the receivables growth rate.

	20x7	***20x8***	***20x9***
Revenue growth	-	12.23%	7.77%
Receivable growth	-	23.46%	37.17%
Ratio		52.15%	20.92%

(Study Session 6, Module 17.3, LOS 17.h)

Related Material

SchweserNotes - Book 2

Question #59 of 63

Question ID: 1209179

Which of the following is *least likely* an indicator of high-quality cash flow?

A) Total cash flow that is positive and high.

B) OCF derived from sustainable sources.

C) OCF adequate to cover capital expenditures, dividends and debt repayments.

Explanation

High-quality cash flow focuses on positive, adequate and sustainable *operating* cash flow. Firms with high borrowings could have high total cash flow but such cash flows would not be sustainable (nor considered high-quality).

(Study Session 6, Module 17.4, LOS 17.i)

Related Material

SchweserNotes - Book 2

Question #60 of 63

Question ID: 1209178

High-quality cash flow is *least likely* to be characterized by:

A) No significant differences between operating cash flow and reported earnings.

B) Financing cash flows sufficient to cover capital expenditures, dividends and debt repayments.

C) Volatility of operating cash flow being lower than that of the firm's peers.

Explanation

High-quality cash flow is characterized by positive OCF that is derived from sustainable sources and is adequate to cover capital expenditures, dividends, and debt repayments. Furthermore, high-quality OCF is characterized by lower volatility than that of the firm's peers. Significant differences between OCF and earnings, or differences that widen over time, can be an indicator of earnings manipulation.

(Study Session 6, Module 17.4, LOS 17.i)

Related Material

SchweserNotes - Book 2

Question #61 of 63

Question ID: 1209139

Junior analyst Xander Marshall sends an e-mail to his boss, Janet Jacobs, CFA, suggesting that Peterson Novelties is manipulating its results to artificially inflate profits. He cites four reasons for his conclusion:

The LIFO reserve is declining.
Earnings are much higher in the September quarter than in other quarters.
Many nonoperating and nonrecurring gains are being recorded as revenue.
Much of Peterson's earnings come from equity investments not reflected on the cash-flow statement.

Jacobs is less concerned about Peterson's earnings than Marshall is, though she does resolve to check out one of his concerns. Which of Marshall's observations *best* supports his conclusion?

A) The declining LIFO reserve.

B) Equity investment earnings not reflected on the cash-flow statement.

C) Nonoperating and nonrecurring gains recorded as revenue.

Explanation

On its own, a declining LIFO reserve is not a sign of fraud. Peterson Novelties could have simply moved a lot of inventory and disclosed the LIFO liquidation in its footnotes. When unusual gains are recorded as revenue they will artificially boost sales growth. Each of the above issues are potential danger signs, but can also be easily explained in a manner beyond reproach. However, earnings from equity investments that do not generate cash flow are of very low quality and warrant further examination.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #62 of 63

Question ID: 1209141

Which of the following statements about operating income and operating cash flow are correct or incorrect?

Statement #1:	If operating income is growing faster than operating cash flow over the long-term, the firm may be recognizing revenue too soon or delaying the recognition of expense.
Statement #2:	Operating cash flow exceeding operating income is sustainable over the long-term.

A) Both are correct. ✗

B) Only one is correct. ✓

C) Both are incorrect. ✗

Explanation

Statement #1 is correct. If operating income and operating cash flow are growing at different rates over the long-term, the firm may be engaging in earnings manipulation. Statement #2 is incorrect. Over the long-term, operating cash flow will eventually decline without the support of operating income.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2

Question #63 of 63

Question ID: 1209144

William Jones, CFA, is analyzing the financial performance of two U.S. competitors in connection with a potential investment recommendation of their common stocks. He is particularly concerned about the quality of each company's financial results in 2007–2008 and in developing projections for 2009 and 2010 fiscal years.

Adams Company has been the largest company in the industry, but Jefferson Inc. has grown more rapidly in recent years. Adams's net sales in 2004 were 33-1/3% higher than Jefferson's but were only 18% above Jefferson's in 2008. During 2008, a slowing U.S. economy led to lower domestic revenue growth for both companies. The 10-k reports showed overall sales growth of 6% for Adams in 2008 compared to 7% for 2007 and 9% in 2006. Jefferson's gross sales rose almost 12% in 2008 versus 8% in 2007 and 10% in 2006. In the past three years, Jefferson has expanded its foreign business at a faster pace than Adams. In 2008, Jefferson's growth in overseas business was particularly impressive. According to the company's 10-k report, Jefferson offered a sales incentive to overseas customers. For those customers accepting the special sales discount, Jefferson shipped products to specific warehouses in foreign ports rather than directly to those customers' facilities.

In his initial review of Adams's and Jefferson's financial statements, Jones was concerned about the quality of the growth in Jefferson's sales, considerably higher accounts receivables, and the impact of overall accruals on earnings quality. He noted that Jefferson had instituted an accounting change in 2008. The economic life for new plant and equipment investments was determined to be five years longer than for previous investments. For Adams, he noted that the higher level of inventories at the end of 2008 might be cause for concern in light of a further slowdown expected in the U.S. economy in 2009.

The accompanying table shows financial data for both companies' Form 10-k reports for 2006–2008 used by Jones for his analysis. To evaluate sales quality, he focused on trends in sales and related expenses for both companies as well as cash collections and receivables comparisons. Inventory trends relative to sales and the number of days' sales outstanding in inventory were determined for both companies. Expense trends were examined for Adams and Jefferson relative to sales growth and accrual ratios on a balance sheet and cash flow basis were developed as overall measures of earnings quality.

	Adams Company			**Jefferson Inc.**		
($ in thousands)	**2006**	**2007**	**2008**	**2006**	**2007**	**2008**
Gross sales	32,031	34,273	36,330	25,625	27,675	30,900
Sales discounts, returns, and allowances	781	836	886	625	675	900

Net sales	31,250	33,438	35,444	25,000	27,000	30,000
Cost of goods sold	15,312	16,384	17,367	12,250	13,250	15,500
SG&A expenses	9,028	9,660	10,240	7,222	7,800	8,200
Depreciation expense	625	669	709	500	515	516
Interest expense	400	428	454	360	366	396
Income before taxes	5,835	6,243	6,618	4,668	5,069	5,388
Taxes (tax rate 40%)	2,334	2,497	2,647	2,000	2,028	2,155
Net income	3,501	3,746	3,971	2,668	3,041	3,233
Dividends	3,000	3,180	3,307	2,460	2,760	2,880
Net addition to retained earnings	501	566	664	208	281	353
Balance Sheet						
Cash and equivalents	150	160	170	120	130	120
Short-term marketable securities	250	325	345	200	217	195
Accounts receivable (net)	15,875	16,758	17,763	12,700	13,000	15,892
Inventories	6,500	6,850	7,800	5,200	5,200	4,500
PP&E (net of depreciation)	8,562	8,991	9,440	6,850	7,057	7,200
Total assets	31,337	33,084	35,518	25,070	25,604	27,907
Accounts payable	7,062	7,880	9,300	6,050	6,100	6,398
Other current liabilities	337	400	450	270	373	1,525
Long-term debt	7,500	7,800	8,100	6,000	6,100	6,600
Common stock	15,000	15,000	15,000	12,000	12,000	12,000
Retained earnings	1,438	2,004	2,668	750	1,031	1,384
Total liabilities and shareholders	31,337	33,084	35,518	25,070	25,604	27,907

equity						
% change gross sales		7.0%	6.0%		8.0%	11.7%
% change sales discounts and allowances		6.0%	6.0%		8.0%	33.3%
% change net sales		7.0%	6.0%		8.0%	11.1%
% change cost of goods sold		7.0%	6.0%		8.0%	17.0%
% change in SG&A		6.0%	6.0%		8.0%	5.1%
% change in depreciation expense		6.0%	6.0%		3.0%	0.2%
% change in accounts receivable		6.0%	6.0%		2.0%	22.3%
% change in inventories		5.0%	13.8%		0.0%	(13.5%)
Revenues % cash collections	1.03	1.03	1.03	1.0	1.0	1.1
Days inventory outstanding	155	153	164	144	143	106
Balance sheet accrual ratio	3.4%	3.5%	3.9%	2.0%	2.4%	10.1%
Cash flow accrual ratio	3.4%	3.5%	3.8%	2.0%	2.0%	4.3%

Jones observed that comparisons of 2007–2008 trends in sales, accounts receivables, and cash collections showed:

A) Jefferson's sales growth accelerated in 2008 compared to Adams's, but cash collections declined as indicated by the rise in receivables and the

B) Jefferson's higher increase in sales relative to Adams's led to improvement in cash collections indicated by the rise in the revenue/collections ratio. There was

C) Jefferson's decline in cash and equivalents in 2008 resulted in lower cash collections despite strong sales growth; Adams's showed similar growth in cash

Explanation

The increase in Jefferson's revenues relative to cash collections along with the large increase in accounts receivable indicates declining cash collections in 2008 compared to its experience in 2007 and relative to Adams's, which showed consistency in both years.

(Study Session 6, Module 17.1, LOS 17.b)

Related Material

SchweserNotes - Book 2