




Question #1 of 28

Question ID: 1457914

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

- A) unstable organizational structure and deficient internal controls. 
- B) inappropriate ethical standards and failing to correct known reportable conditions. 
- C) opportunity, motivation, and rationalization. 

Explanation




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

(Module 26.1, LOS 26.e)

Question #2 of 28

Question ID: 1457904

On a spectrum for assessing financial reporting quality, which of the following represents the highest quality?

- A) Reporting is compliant with GAAP but reporting choices and estimates are biased. 
- B) Reporting is compliant with GAAP and decision useful but earnings are not sustainable. 
- C) Reporting is not compliant with GAAP but the numbers presented reflect the company's actual activities. 

Explanation




A firm can have high financial reporting quality even if its earnings quality is low, such as a firm that recognizes one-time gains in a period and identifies them clearly. Biased accounting choices and non-compliance with GAAP represent lower-quality financial reporting.

(Module 26.1, LOS 26.b)

Question #3 of 28

Question ID: 1457901

If a firm's financial reports are of low quality, can users of the reports assess the quality of the firm's earnings?

- A) Yes, because if financial reports are of low quality, earnings are also of low quality. 
- B) Yes, because users can assess earnings quality independently of financial reporting quality. 
- C) No, because low-quality financial reports are not useful for assessing the quality of earnings. 

Explanation




Financial reports that are of low quality make it difficult or impossible for users of the statements to assess the quality of the firm's earnings, cash flows, and balance sheet values.

(Module 26.1, LOS 26.a)

Question #4 of 28

Question ID: 1457917

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

- A) government securities regulators. 
- B) accounting standard-setting bodies. 
- C) counterparties to private contracts. 

Explanation




Accounting standard-setting bodies issue financial reporting standards but do not enforce compliance with them. Securities regulators and counterparties to private contracts are among the mechanisms that discipline financial reporting quality.

(Module 26.1, LOS 26.f)

Question #5 of 28

Question ID: 1457905

A spectrum for assessing financial reporting quality should consider:

- A) both quality of financial reports and quality of earnings. 
- B) quality of financial reports only. 
- C) quality of earnings only. 

Explanation

Both quality of financial reports and quality of reported earnings are elements that should be considered in a spectrum for assessing financial reporting quality.

(Module 26.1, LOS 26.b)

Question #6 of 28

Question ID: 1457924

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

A) investing activities.



B) financing activities.



C) operating activities.



Explanation

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

(Module 26.2, LOS 26.h)

Question #7 of 28

Question ID: 1457903

The quality of a company's reported earnings is low when they:

A) do not conform to GAAP.



B) are not sustainable.



C) are lower than for the prior-year period.



Explanation




The quality of a firm's earnings is considered to be low if they are not sustainable or if they are not of a sufficient level to provide an adequate return to investors. When financial reports do not conform with GAAP, the user cannot evaluate the quality of earnings in terms of adequacy or sustainability.

(Module 26.1, LOS 26.a)

Question #8 of 28

Question ID: 1457918

A mechanism to discipline financial reporting quality for securities that trade in the United States that is not typically imposed on security issuers elsewhere is that:

- A) financial statements must be audited by an independent party. 
- B) the firm must provide a signed statement by the person responsible for preparing the financial statements. 
- C) management must attest to the effectiveness of the firm's internal controls. 

Explanation

A signed management statement about the effectiveness of the firm's internal controls is required by U.S. regulators for securities that trade in the U.S., but not elsewhere. The other two items are typically required by securities regulators worldwide.

(Module 26.1, LOS 26.f)

Question #9 of 28

Question ID: 1457921

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

- A) overstate earnings. 
- B) understate earnings. 
- C) overstate liabilities. 

Explanation



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

(Module 26.2, LOS 26.h)

Question #10 of 28

Question ID: 1457920

An IFRS-reporting firm includes in its financial statements a measure that is not defined under IFRS. The firm is *least likely* required to:

- A) reconcile this measure with the most comparable IFRS measure. 
- B) show this measure for all periods presented. 

C) define and explain the relevance of this measure.



Explanation

IFRS require firms that present a non-GAAP (i.e., non-IFRS) measure in their financial reports to define the measure and explain its relevance, and to reconcile the differences between this measure and the most comparable IFRS measure.

(Module 26.1, LOS 26.g)

Question #11 of 28

Question ID: 1457923

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

A) Decreasing the salvage value of depreciable assets.



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



C) Selling more inventory than is purchased or produced.



Explanation

Decreasing the salvage value will result in higher depreciation expense and lower earnings in the current period. Recognizing revenue before fulfilling all terms of a sale is an aggressive revenue recognition method that will increase earnings in the current period. For firms that use LIFO inventory accounting and in an increasing price environment, selling more inventory than is purchased or produced will increase earnings unsustainably in the current period.

(Module 26.2, LOS 26.h)

Question #12 of 28

Question ID: 1457915

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

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



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



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



Explanation




A large range of acceptable accounting treatments is conducive to manager bias affecting the quality of financial reporting. In such a circumstance, misleading estimates and accounting choices that do not flow from the economic reality of a firm's transactions fall more into the category of mistakes rather than fraudulent reporting. Potentially violating debt covenants is considered a motivation for low quality financial reporting. Variability of earnings could be a motivating factor for earnings smoothing but are not necessarily conducive to low quality financial reporting.

(Module 26.1, LOS 26.e)

Question #13 of 28

Question ID: 1457912

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

- A) Accounting controls are weak within the company. 
- B) Enhancement of the manager's career. 
- C) Keeping earnings above the same period in the prior year. 

Explanation

Weak accounting controls may offer an opportunity to issue low quality reports but is not in itself a motivation to do so. The other two choices are motivations that might cause management to issue low quality financial reports.

(Module 26.1, LOS 26.d)

Question #14 of 28

Question ID: 1457922

If management is manipulating financial reporting to avoid breaching an interest coverage ratio covenant on the firm's debt, they are *most likely* to:

- A) capitalize leases. 
- B) understate assets. 
- C) overstate earnings. 

Explanation




Debt covenants may require a firm to maintain a minimum interest coverage ratio (EBIT / interest expense). Manipulating the financial statements to increase the interest coverage ratio would most likely involve overstating earnings, or possibly understating liabilities (for example by using operating leases instead of capital leases) to decrease interest expense. Understating or overstating assets would not affect the interest coverage ratio.

(Module 26.2, LOS 26.h)

Question #15 of 28

Question ID: 1457926

A significant increase in days payables above historical levels is *most likely* associated with:

- A) an increase in net working capital. 
- B) an unsustainable increase in reported earnings. 
- C) low quality of the cash flow statement. 

Explanation




A significant increase in days payables may indicate that payables have been "stretched" (not paid or paid more slowly), which increases operating cash flow in an unsustainable manner and calls the quality of the reported cash flow values into question. Stretching payables does not affect earnings because the related expenses were recognized in the period incurred. An increase in days payables will decrease net working capital, other things equal.

(Module 26.3, LOS 26.i)

Question #16 of 28

Question ID: 1462856

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

- A) poor financial controls. 
- B) rationalization of the actions. 
- C) pressure to meet earnings expectations. 




Explanation

A mindset that allows rationalization is the third important condition underlying low-quality financial reporting. Poor financial controls are an example of opportunity and pressure to meet earnings expectations is a possible motivation. (Module 26.1, LOS 26.e)

Question #17 of 28

Question ID: 1462857

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

- A) has an operating cash flow to net income ratio greater than one. 
- B) increases the estimated useful lives and salvage values of several physical assets. 
- C) has substantial changes in management's commentary every reporting period. 

Explanation




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

If the ratio of operating cash flow to net income is *less* than 1.0 consistently, the company is reporting higher earnings than are likely to be supportable by its operating performance. Management's commentary *should* change every reporting period. Commentary that is similar across periods suggests management is lax in its responsibility for financial reporting. (Module 26.3, LOS 26.i)

Question #18 of 28

Question ID: 1457927

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

- A) Higher estimated salvage values than are typical in a firm's industry. 
- B) Capitalizing purchases that comparable firms typically expense. 
- C) More aggressive revenue recognition methods than comparable firms. 

Explanation




Capitalizing purchases that other firms expense increases reported CFO by classifying the cash outflows as CFI. Revenue recognition methods and accounting estimates may affect reported income but are unlikely to affect the amount or classification of cash flows.

(Module 26.3, LOS 26.i)

Question #19 of 28

Question ID: 1457906

Which of the following is *least likely* one of the combinations of the quality of financial reporting and quality of reported earnings along the spectrum of financial report quality?

- A) Reporting is not compliant with GAAP, although reported earnings are sustainable and adequate. 
- B) Reporting is not compliant and includes numbers that are fictitious or fraudulent. 
- C) Reporting is compliant with GAAP, but the amount of earnings is actively managed to smooth earnings. 

Explanation

When reporting is not compliant with GAAP, the sustainability and adequacy of reported earnings cannot be determined. The other two choices fall on the spectrum of the quality of financial reports.

(Module 26.1, LOS 26.b)

Question #20 of 28

Question ID: 1457902

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

- A) Completeness. 
- B) Sustainability. 
- C) Relevance. 

Explanation

Quality of earnings relates to the level and sustainability of a firm's earnings. Relevance and faithful representation (including completeness and neutrality) are characteristics of a firm's financial reporting quality.

(Module 26.1, LOS 26.a)

Question #21 of 28

Question ID: 1457913

Samantha Cameron, CFA, is analyzing the financial reporting quality of Redd Networks. Cameron examines how the company is responding to strict debt covenants and investigates executives' holdings of stock and options in the firm, which are believed to be quite high. Which condition that may lead to low-quality financial reporting is Cameron investigating?

A) Rationalization.



B) Opportunity.



C) Motivation.



Explanation

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

(Module 26.1, LOS 26.e)

Question #22 of 28

Question ID: 1457919

With regard to a firm's financial reporting quality, an analyst should *most likely* interpret as a warning sign a focus by management on an increase in the firm's:

A) cash from operations.



B) asset turnover ratios.



C) pro forma earnings.



Explanation

One potential warning sign of low-quality financial reporting is management's focus on "pro forma" or non-GAAP measures of earnings. Increases in operating cash flows or asset turnover ratios are not typically viewed as warning signs of poor financial reporting quality.

(Module 26.1, LOS 26.g)

Question #23 of 28

Question ID: 1457909

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

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



B) earnings are less than analysts expect.



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



Explanation

Meeting analysts' earnings expectations may motivate management to produce low-quality financial reports. Earning compensation based on the share price and avoiding breaches of loan covenants are also possible motivations.

(Module 26.1, LOS 26.d)

Question #24 of 28

Question ID: 1457925

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

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



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



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



Explanation

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

(Module 26.2, LOS 26.h)

Question #25 of 28

Question ID: 1457910

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

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



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

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



Explanation


Management might be motivated to "manage earnings" by making conservative choices and estimates in periods when earnings are higher than expected, delaying recognition of some of these earnings to later periods. Meeting debt covenants or improving stock performance in the near term are more likely to motivate management to make aggressive accounting choices and estimates.

(Module 26.1, LOS 26.d)

Question #26 of 28

Question ID: 1457911

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

- A) Debt covenants. 
- B) Disclosure regulations. 
- C) Audit requirements. 

Explanation




Debt covenants that require a firm to meet minimum financial measures may give management an incentive to manipulate earnings. Audit requirements and disclosure regulations are mechanisms that discipline financial reporting quality.

(Module 26.1, LOS 26.d)

Question #27 of 28

Question ID: 1457908

With regard to the goal of neutrality in financial reporting, accounting standards related to research costs and litigation losses should be viewed as:

- A) promoting neutral financial reporting. 
- B) biased toward aggressive financial reporting. 
- C) biased toward conservative financial reporting. 

Explanation

Some accounting principles, such as IFRS and U.S. GAAP standards for expensing research costs and recognizing probable litigation losses, reflect conservatism rather than neutrality, in that they require earlier recognition of probable losses and later recognition of probable gains.

(Module 26.1, LOS 26.c)

Question #28 of 28

Question ID: 1457907

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

- A) comply with generally accepted accounting principles.
- B) produce decision-useful financial reporting.
- C) report sustainable earnings.



Explanation

Management may follow generally accepted accounting principles and still make biased (i.e., aggressive or conservative) accounting choices. Biased accounting choices diminish the decision-usefulness of financial reporting. Aggressive accounting choices are those that increase earnings, revenues, or operating cash flows in the current period (and likely reduce them in later periods).

(Module 26.1, LOS 26.c)