25 FINANCIAL REPORTING QUALITY

1. Which of the following accounting warning signs is most likelyto indicate manipulation of reported operating cash flows?
   (A) More aggressive revenue recognition methods than comparable firms.
   (B) Capitalizing purchases that comparable firms typically expense.
   (C) Higher estimated salvage values than are typical in a firm's industry.

2. Mechanisms that enforce discipline over financial reporting quality least likely include:
   (A) government securities regulators.
   (B) counterparties to private contracts.
   (C) accounting standard-setting bodies.

3. Aggressive accounting choices by management are most likelyto:
   (A) produce decision-useful financial reporting.
   (B) comply with generally accepted accounting principles.
   (C) report sustainable earnings.

4. On a spectrum for assessing financial reporting quality, which of the following represents the highest quality?
   (A) Reporting is compliant with GAAP and decision useful but earnings are not sustainable.
   (B Reporting is not compliant with GAAP but the numbers presented reflect the company's actual activities.
   (C) Reporting is compliant with GAAP but reporting choices and estimates are biased.

5. While motivation and opportunity both can lead to low quality of financial reporting, a third important contributing factor is:
   (A) rationalization of the actions.
   (B) pressure to meet earnings expectations.
   (C) poor financial controls.

6. In which of the following situations is management most likelyto make conservative choices and estimates that reduce the quality of financial reports?
   (A) Management's compensation is closely tied to near-term performance of the firm's stock.
   (B) The firm must meet accounting benchmarks to comply with debt covenants.
   (C) Earnings for a period will be higher than analysts' expectations.

7. Which of the following is one of circumstances that is conducive to issuing low-quality financial reports?
   (A) Earnings per share are highly variable from year to year.
   (B) There is a large range of acceptable accounting treatments.
   (C) Balance sheet values are likely to violate debt covenants.

8. A spectrum for assessing financial reporting quality should consider:
   (A) both quality of financial reports and quality of earnings.
   (B) quality of earnings only.
   (C) quality of financial reports only.

9. Conditions that may cause firms to issue low-quality financial reports are best described as:
   (A) unstable organizational structure and deficient internal controls.
   (B) opportunity, motivation, and rationalization.
   (C) inappropriate ethical standards and failing to correct known reportable conditions.

10. 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.

11. With regard to the goal of neutrality in financial reporting, accounting standards related to research costs and litigation losses should be viewed as:
   (A) biased toward aggressive financial reporting.
   (B) biased toward conservative financial reporting.
   (C) promoting neutral financial reporting.

12. 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) decrease the assumed useful lives of plant and equipment.
   (B) increase the assumed residual values of plant and equipment.
   (C) write up plant and equipment from depreciated cost to its fair market value.

13. 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.

14. A significant increase in days payables above historical levels is most likely associated with:
   (A) an unsustainable increase in reported earnings.
   (B) an increase in net working capital.
   (C) low quality of the cash flow statement.

15. 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.

16. Compared to a firm that appropriately expenses recurring maintenance costs, a firm that capitalizes these costs will report greater cash flow from:
    (A) financing activities.
    (B) operating activities.
    (C) investing activities.

17. An analyst would most likelysuspect 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.

18. Which of the following actions is least likelyto 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.

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

20. Under which inventory cost flow assumption is a firm most likely to show an unusual increase in gross profit margin by sales in excess of current period production?
    (A) Average cost.
    (B) LIFO.
    (C) FIFO.

21. If management is manipulating financial reporting to avoid breaching an interest coverage ratio covenant on the firm's debt, they are most likely to:
    (A) understate assets.
    (B) capitalize leases.
    (C) overstate earnings.

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

23. Which of the following is most accurately described as a characteristic of a firm's quality of earnings?
    (A) Sustainability.
    (B) Completeness.
    (C) Relevance.

24. With regard to a firm's financial reporting quality, an analyst should most likely interpret as a warning sign a focus by management on an increase in the firm's:
    (A) pro forma earnings.
    (B) cash from operations.
    (C) asset turnover ratios.

25. Joe Carter, CFA, believes Triangle Equipment, a maker of large, specialized industrial equipment, has overstated the salvage value of its equipment. This would:
    (A) overstate liabilities.
    (B) overstate earnings.
    (C) understate earnings.

26. Management is most likely to be motivated to produce low-quality financial reports when:
    (A) earnings are less than analysts expect.
    (B) the firm is not required to abide by loan covenants.
    (C) managers' compensation is unrelated to the firm's share price.

27. 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) management must attest to the effectiveness of the firm's internal controls.
    (C) the firm must provide a signed statement by the person responsible for preparing the financial statements.

28. Which of the following is least likelyone 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 compliant with GAAP, but the amount of earnings is actively managed to smooth earnings.
    (C) Reporting is not compliant and includes numbers that are fictitious or fraudulent.

29. 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.