J.K. SHAH® ONLINE
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12 EVALUATING QUALITY OF FINANCIAL REPORTS

1. High-quality cash flow is least likely to be characterized by:
   (A) Volatility of operating cash flow being lower than that of the firm's peers.
   (B) No significant differences between operating cash flow and reported earnings.
   (C) Financing cash flows sufficient to cover capital expenditures, dividends and debt repayments.

2. 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) Low earnings should not be expected to continue indefinitely.
   (B) Normal earnings should not be expected to continue indefinitely.
   (C) High earnings should not be expected to continue indefinitely.

3. 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.

($ in thousands)	Adams Company			Jefferson Inc.		
	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 Sheet3						
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 equity	31,337	33,084	35,518	25,070	25,604	27,907
% 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 account 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) 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 depreciation expense and slower growth in SG&A relative to the company's previous year and compared to Adams's trends.

(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 lives while the slower SG&A growth may reflect expense controls imposed to offset lower, gross profit margins.

(C) 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 economy.

4. 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.

5. 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 the same period.
   (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 different periods.

6. Pysha Heavy Metals Ltd. supplies specialized metals to the chip fabrication industry. Selected financial data for Pysha, as well as industry comparable, 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)	Lower	Higher
(B)	Higher	Higher
(C)	Higher	lower

7. The failure to recognize inventory obsolescence is an example of_______________.
   (A) Delaying expenses.
   (B) Understating expenses.
   (C) Misclassifying expenses.

8. Sustainable earnings are most likely to be driven by:
   (A) Cash flow element of earnings.
   (B) Conservative revenue recognition practices.
   (C) Accruals element of earnings.

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

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

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

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

10. 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) $103,500.

   (C) $106,800.

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11. 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		
In thousands	Year ended December 31,	
	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 finance (capital) leases lowers earnings quality.

(C) The treatment of the receivables sale lowers earnings quality.

12. 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.

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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) Only net income is overstated.

(B) Net income and inventory turnover are overstated.

(C) Only inventory turnover is overstated.

13. Aggressive revenue recognition practices are least likely to increase:

(A) reported expenses

(B) reported assets

(C) reported ending inventory

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

(B) Low-quality due to lack of completeness.

(C) Low-quality due to bias in measurement.

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

(A) compliant with GAAP and sustainable.

(B) non-compliant with GAAP.

(C) compliant with GAAP but not sustainable.

16. Complete the following sentence. The cash component of income is___________ than the accrual component.

(A) the same persistence.

(B) less persistent.

(C) more persistent.

17. Which of the following items is least likely to involve the use of subjective measurement estimates
    (A) Use of straight-line depreciation method to depreciate tangible assets.
    (B) Use of criteria to determine treatment as an extraordinary item.
    (C) Use of FIFO (first in-first out) to cost inventories.

18. 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.

19. Which of the following is least likely an indicator of biased measurement in assessing balance sheet quality?
    (A) Understatement of valuation allowance for deferred tax assets.
    (B) Presence of substantial goodwill on balance sheet.
    (C) Understatement of inventory impairment charges.

20. High results quality is most likely demonstrated by:
    (A) high level of earnings determined conservatively.
    (B) GAAP compliant financial reports that are decision useful.
    (C) an adequate level of return that is sustainable.

21. Errors that affect multiple financial statement elements are most likely to arise from:
    (A) measurement and timing issues.
    (B) compound issues.
    (C) classification issues.

22. 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) One is included.
    (B) Both are excluded.
    (C) Both are included.

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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.

24. 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 1 is correct.

(B) None of the statements is correct.

(C) Only statement 2 is correct.

25. 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) an increase in M-score.

(B) revenue inflation.

(C) a decrease in probability of earnings manipulation.

26. Mean reversion in earnings means that:

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

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

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

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

(B) Check Zartner's cash-flow statement and review its footnotes.

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

28. 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) Northern is stretching payables.

(B) Days sales outstanding is probably increasing.

(C) Northern may have accelerated revenue recognition.

29. 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.

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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 equity	31,337	33,084	35,518	25,070	25,604	27,907
% 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 account 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) 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 Adams.

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

30. 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
Receivable turnover	16.2	16.0	16.3

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

(A) Pysha's revenues are growing at a faster rate than its receivables.

(B) Pysha's revenues are growing at a slower rate than its receivables.

(C) The revenues growth rate divided by receivables growth rate is increasing over time.

31. 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 degree of persistence of earnings.

(B) Higher level of earnings.

(C) Higher degree of conservatism of earnings.

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

(A) Overly high assumed discount rate for pension obligations.

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

(C) Understatement of impairment charges for property, plant, and equipment.

33. Which one of the following choices is least likely to be an indicator of poor-quality earnings?
    (A) Reported earnings handily beat analyst estimates.
    (B) An investigation by the market regulatory authority is initiated.
    (C) Restatement of previously issued financial statements.

34. 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		
In thousands	Year ended December 31,	
	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) High Plains' extreme revenue growth will likely revert back to normal levels over time.

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

(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.

35. 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.

36. Complete the following sentence. When earnings are relatively free of accruals, mean reversion will occur_________.
    (A) relatively slower than usual.
    (B) relatively faster than usual.
    (C) at the same rate as usual.

37. 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	Correct
(B)	Correct	Incorrect
(C)	Incorrect	Incorrect

38. 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) Disproportionate revenues in the last quarter of the calendar year.
    (B) Implementing a "bill and hold" arrangement.
    (C) Use of barter transactions.

39. 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) Only statement #2 is incorrect.
    (B) Only statement #1 is incorrect.
    (C) Both are incorrect.

40. **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 classification of the majority of Hartford's leases as operating leases.

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

41. 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.

($ in thousands)	Adams Company			Jefferson Inc.		
	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 equity	31,337	33,084	35,518	25,070	25,604	27,907
% 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 account 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%

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Based on the financial results of Adams and Jefferson in 2007 and 2008, the Company

(A) Jefferson due to sharply higher accruals ratios and less conservative accounting methods indicated by the change in depreciation policies and the impact of changes in shipment terms on revenue recognition and inventories for the special overseas offer.

(B) Adams due to slower revenue growth, higher expense growth compared to Jefferson, possible inventory obsolescence related to higher 2008 inventories despite slowing customer demand, and lower balance sheet and cash flow based accrual ratios in 2008 compared to Jefferson.

(C) Adams due to lower cash collection measures, possible inventory obsolescence related to higher 2008 inventories despite slowing customer demand, higher expense growth compared to Jefferson, and lower balance sheet and cash flow accrual ratios relative to Jefferson.

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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.

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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 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 no change in Adams's cash collections in 2008.

(B) Jefferson's sales growth accelerated in 2008 compared to Adams's, but cash collections declined as indicated by the rise in receivables and the revenue/collections ratio; Adams's sales, accounts receivables, and cash collections rose at similar rates in 2008.

(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 and equivalents and accounts receivable relative to sales gains.

43. 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 higher weighting.

(B) a lower weighting.

(C) the same weighting.

44. 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 provides more timely and relevant information to users about future cash flows.

(B) Yes.

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

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

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

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

46. 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) Equity investment earnings not reflected on the cash-flow statement.
    (B) Nonoperating and nonrecurring gains recorded as revenue.
    (C) The declining LIFO reserve.

47. 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) Beta Mart.
(B) Allied Stores.
(C) Cash-N-Carry.

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48. 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.

($ in thousands)	Adams Company			Jefferson Inc.		
	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 equity	31,337	33,084	35,518	25,070	25,604	27,907
% 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 account 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, indicating a decline in earnings quality compared to previous years and lower earnings quality relative to Adams's in 2008.

(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, thus demonstrating significant improvement in earnings quality relative to Adams's.

49. 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

50. To assess the quality of financial reports, which question is least necessary for an analyst to answer?
(A) Are the financial reports decision useful and GAAP compliant?
(B) Are reported earnings consistent with the firm's budget?
(C) Do earnings represent an adequate level of return?

51. 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 1 only.
(B) None of the statements is accurate.
(C) Statement 2 only.

52. 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.

53. 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.

($ in thousands)	Adams Company			Jefferson Inc.		
	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
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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 levels may be understated and sales overstated to the extent of product shipments for the special offer; Adams's inventory increase may reflect slowing product demand and possible inventory obsolescence.

(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 suggests possible inventory obsolescence.

(C) Jefferson's inventory decline suggests possible problems in inventory management to meet the stronger customer demand from the special offer; Adams's large inventory increase suggests better inventory management to meet future sales growth.

54. 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.

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55. Classification shifting is least likely to result in a higher:

(A) reported net income.

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

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

56. 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) Only one is correct.

(B) Both are incorrect.

(C) Both are correct.

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

    (A) Auditor's report.

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

    (C) Notes to financial statements.

58. 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.