CHAPTER 12

EVALUATING QUALITY OF FINANCIAL REPORTS

1. **(B)** **Managing 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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

2. **(C)** **With the cash basis, revenues and expenses relating to the equipment are generally recognized in different periods.**

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.

(Module 12.2, LOS 12.f)

Related Material

SchweserNotes - Book 2

3. (C) **Financing cash flows sufficient to cover capital expenditures, dividends and debt repayments.**

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.

(Module 12.4, LOS 12.I)

Related Material

SchweserNotes - Book 2

4. (C) **$106,800.**

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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

5. (B) **Normal 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.

(Module 12.3, LOS 12.g)

Related Material

SchweserNotes - Book 2

6. (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.

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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

7. **DSO** **Receivables turnover**

(C) **Higher** **lower**

Explanation

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

DSO	18.25	20.08	25.55
Receivables 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.

(Module 12.3, LOS 12.h)

Related Material

SchweserNotes - Book 2

8. **(B)** **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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

9. **(B)** **Understating 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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

10. (A) 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).

(Module 12.3, LOS 12.g)

Related Material

SchweserNotes - Book 2

11. (C) The treatment of the receivables sale 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.

(Module 12.3, LOS 12.h)

Related Material

SchweserNotes - Book 2

12. (B) Net income and inventory turnover are 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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

13. (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).

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

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

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.

(Module 12.5, LOS 12.k)

Related Material

SchweserNotes - Book 2

15. (C) compliant with GAAP but not 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.

(Module 12.2, LOS 12.f)

Related Material

SchweserNotes - Book 2

16. (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.
(Module 12.2, LOS 12.f)
Related Material
SchweserNotes - Book 2

17. (B) **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.
(Module 12.1, LOS 12.b)
Related Material
SchweserNotes - Book 2

18. (A) **Total cash flow that is positive and high.**
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).
(Module 12.4, LOS 12.l)
Related Material
SchweserNotes - Book 2

19. (B) **Presence of substantial goodwill on balance sheet.**
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.
(Module 12.5, LOS 12.j)
Related Material
SchweserNotes - Book 2

20. (C) **an adequate level of return that is sustainable.**
Explanation
High results quality occurs if the level of earnings provides an adequate level of return and that the earnings are sustainable.
(Module 12.5, LOS 12.a)

Related Material

SchweserNotes - Book 2

21. (A) measurement and timing 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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

22. (A) One is 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."

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

23. (B) higher.

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%

(Module 12.4, LOS 12.i)

Related Material

SchweserNotes - Book 2

24. (B) None of the statements 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.

(Module 12.2, LOS 12.d)

Related Material

SchweserNotes - Book 2

25. (C) a decrease in probability of earnings manipulation.

Explanation

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

(Module 12.2, LOS 12.c)

Related Material

SchweserNotes - Book 2

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

Explanation

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

(Module 12.3, LOS 12.g)

Related Material

SchweserNotes - Book 2

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

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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

28. (A) Northern is stretching payables.

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.

(Module 12.4, LOS 12.i)

Related Material

SchweserNotes - Book 2

29. (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.

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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

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

Explanation

Pysha's revenues 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%

(Module 12.3, LOS 12.h)

Related Material

SchweserNotes - Book 2

31. (A) 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.

(Module 12.3, LOS 12.f)

Related Material

SchweserNotes - Book 2

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

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.

(Module 12.5, LOS 12.j)

Related Material

SchweserNotes - Book 2

33. (A) Reported earnings handily beat analyst estimates.

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.

(Module 12.2, LOS 12.e)

Related Material

SchweserNotes - Book 2

34. (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).

(Module 12.2, LOS 12.f)

Related Material

SchweserNotes - Book 2

35. (B) overstate earnings.

Explanation

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

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

36. (A) 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.

(Module 12.3, LOS 12.g)

Related Material

SchweserNotes - Book 2

37.	Statement #1	Statement #2
(C)	Incorrect	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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

38. (A) 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 43 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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

39. (C) Both are 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.

(Module 12.2, LOS 12.f)

Related Material

SchweserNotes - Book 2

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

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.

(Module 12.2, LOS 12.e)

Related Material

SchweserNotes - Book 2

41. (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.

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.

(Module 12.3, LOS 12.h)

Related Material

SchweserNotes - Book 2

42. (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.

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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

43. (A) 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.

(Module 12.2, LOS 12.f)

Related Material

SchweserNotes - Book 2

44. (B) Yes.

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.

(Module 12.2, LOS 12.f)

Related Material

SchweserNotes - Book 2

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

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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

46. (A) Equity investment earnings not reflected on the cash-flow statement.

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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

47. (C) Cash-N-Carry.

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.

(Module 12.3, LOS 12.g)

Related Material

SchweserNotes - Book 2

48. (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.

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.

(Module 12.3, LOS 12.h)

Related Material

SchweserNotes - Book 2

49.		Computer division earnings	Automobile division earnings
	(A)	Decrease	Decrease

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).

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

50. (B) Are reported earnings consistent with the firm's budget?

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).

(Module 12.1, LOS 12.a)

Related Material

SchweserNotes - Book 2

51. (B) 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.

(Module 12.2, LOS 12.d)

Related Material

SchweserNotes - Book 2

52. (A) 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.

(Module 12.2, LOS 12.e)

Related Material

SchweserNotes - Book 2

53. (A) 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.

(Module 12.5, LOS 12.m)

Related Material

SchweserNotes - Book 2

54. (A) Reduced reported earnings in 20X4 while increasing 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.

(Module 12.4, LOS 12.i)

Related Material

SchweserNotes - Book 2

55. (B) Classification of recurring revenue as nonrecurring revenue.

Explanation

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

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

56. (A) Only one is correct.

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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

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

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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2

58. (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.**

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.

(Module 12.1, LOS 12.b)

Related Material

SchweserNotes - Book 2