CHAPTER 25

FINANCIAL REPORTING QUALITY

1. (B) **Capitalizing purchases that comparable firms typically expense.**

Explanation

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

(Study Session 8, Module 25.3, LOS 25.i)

Related Material

SchweserNotes - Book 2

2. (C) **accounting standard-setting bodies.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.f)

Related Material

SchweserNotes - Book 2

3. (B) **comply with generally accepted accounting principles.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 2

4. (A) **Reporting is compliant with GAAP and decision useful but earnings are not sustainable.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.b)

Related Material

SchweserNotes - Book 2

5. (A) **rationalization of the actions.**

Explanation

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

For Further Reference:

(Study Session 8, Module 25.1, LOS 25.e)

CFA® Program Curriculum, Volume 3, page 508

Related Material

SchweserNotes - Book 2

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

Explanation

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

(Study Session 8, Module 25.1, LOS 25.d)

Related Material

SchweserNotes - Book 2

7. (B) **There is a large range of acceptable accounting treatments.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.e)

Related Material

SchweserNotes - Book 2

8. (A) **both quality of financial reports and quality of earnings.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.b)

Related Material

SchweserNotes - Book 2

9. (B) **opportunity, motivation, and rationalization.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.e)

Related Material

SchweserNotes - Book 2

10. (A) **Accounting controls are weak within the company.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.d)

Related Material

SchweserNotes - Book 2

11. (B) **biased toward conservative financial reporting.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 2

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

Explanation

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

(Study Session 8, Module 25.2, LOS 25.h)

Related Material

SchweserNotes - Book 2

13. (B) **are not sustainable.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.a)

Related Material

SchweserNotes - Book 2

14. (C) **low quality of the cash flow statement.**

Explanation

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

(Study Session 8, Module 25.3, LOS 25.i)

Related Material

SchweserNotes - Book 2

15. (A) **Debt covenants.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.d)

Related Material

SchweserNotes - Book 2

16. (B) operating activities.

Explanation

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

(Study Session 8, Module 25.2, LOS 25.h)

Related Material

SchweserNotes - Book 2

17. (B) increases the estimated useful lives and salvage values of several physical assets.

Explanation

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

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

For Further Reference:

(Study Session 8, Module 25.3, LOS 25.i)

CFA® Program Curriculum, Volume 3, page 544

Related Material

SchweserNotes - Book 2

18. (A) Decreasing the salvage value of depreciable assets.

Explanation

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

(Study Session 8, Module 25.2, LOS 25.h)

Related Material

SchweserNotes - Book 2

19. (C) **No, because low-quality financial reports are not useful for assessing the quality of earnings.**

Explanation

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

(Study Session 8, Module 25.1, LOS 25.a)

Related Material

SchweserNotes - Book 2

20. (B) LIFO.

Explanation

Under LIFO and with increasing prices, a firm that sells more goods than it purchases or produces in a period may show an unsustainable increase in gross profit margin because items recognized in cost of sales are valued older, lower prices, while sales are recorded at current, higher prices.

(Study Session 8, Module 25.3, LOS 25.i)

Related Material

SchweserNotes - Book 2

21. (C) overstate earnings.

Explanation

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

(Study Session 8, Module 25.2, LOS 25.h)

SchweserNotes - Book 2

22. (C) Motivation.

Explanation

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

(Study Session 8, Module 25.1, LOS 25.e)

Related Material

SchweserNotes - Book 2

23. (A) Sustainability.

Explanation

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

(Study Session 8, Module 25.1, LOS 25.a)

Related Material

SchweserNotes - Book 2

24. (A) pro forma earnings.

Explanation

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

(Study Session 8, Module 25.1, LOS 25.g)

Related Material

SchweserNotes - Book 2

25. (B) overstate earnings.

Explanation

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

(Study Session 8, Module 25.2, LOS 25.h)

Related Material

SchweserNotes - Book 2

26. (A) earnings are less than analysts expect.

Explanation

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

(Study Session 8, Module 25.1, LOS 25.d)

Related Material

SchweserNotes - Book 2

27. (B) management must attest to the effectiveness of the firm's internal controls.

Explanation

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

(Study Session 8, Module 25.1, LOS 25.f)

Related Material

SchweserNotes - Book 2

28. (B) Reporting is compliant with GAAP, but the amount of earnings is actively managed to smooth earnings.

Explanation

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

(Study Session 8, Module 25.1, LOS 25.b)

Related Material

SchweserNotes - Book 2

29. (B) show this measure for all periods presented.

Explanation

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

(Study Session 8, Module 25.1, LOS 25.g)

Related Material

SchweserNotes - Book 2