38 FINANCIAL REPORTING QUALITY

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

2. Which of the following is least likely one of the combinations of the quality of financial reporting and quality of reported earnings along the spectrum of financial report quality?
   (A) Reporting is not compliant with GAAP, although reported earnings are sustainable and adequate.
   (B) Reporting is not compliant and includes numbers that are fictitious or fraudulent.
   (C) Reporting is compliant with GAAP, but the amount of earnings is actively managed to smooth earnings.

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

4. An analyst would most likely suspect that the quality of a company's earnings is deteriorating if the company:
   (A) has an operating cash flow to net income ratio greater than one.
   (B) increases the estimated useful lives and salvage values of several physical assets.
   (C) has substantial changes in management's commentary every reporting period.

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

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

7. 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.

J.K. SHAH CLASSES a Veranda Enterprise

8. If a firm's management wants to use its discretion over accounting choices to increase operating income in the next period, they are most likely to:
   (A) write up plant and equipment from depreciated cost to its fair market value.
   (B) increase the assumed residual values of plant and equipment.
   (C) decrease the assumed useful lives of plant and equipment.

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

10. Which of the following is least likely to be a motivation for managers to issue financial reports of low quality?
   (A) Accounting controls are weak within the company.
   (B) Enhancement of the manager's career.
   (C) Keeping earnings above the same period in the prior year.

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

12. An IFRS-reporting firm includes in its financial statements a measure that is not defined under IFRS. The firm is least likely required to:
    (A) show this measure for all periods presented.
    (B) define and explain the relevance of this measure.
    (C) reconcile this measure with the most comparable IFRS measure.

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

J.K. SHAH® CLASSES a Veranda Enterprise

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

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

16. A mechanism to discipline financial reporting quality for securities that trade in the United States that is not typically imposed on security issuers elsewhere is that:
    (A) management must attest to the effectiveness of the firm's internal controls.
    (B) the firm must provide a signed statement by the person responsible for preparing the financial statements.
    (C) financial statements must be audited by an independent party.

17. Which of the following requirements are most likely to create incentives for management to manipulate earnings?
   (A) Debt covenants.
   (B) Disclosure regulations.
   (C) Audit requirements.

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

19. The quality of a company's reported earnings is low when they:
   (A) are not sustainable.
   (B) do not conform to GAAP.
   (C) are lower than for the prior-year period.

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

J.K. SHAH CLASSES a Veranda Enterprise

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

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

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

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

25. If a firm's financial reports are of low quality, can users of the reports assess the quality of the firm's earnings?
    (A) No, because low-quality financial reports are not useful for assessing the quality of earnings.
    (B) Yes, because users can assess earnings quality independently of financial reporting quality.
    (C) Yes, because if financial reports are of low quality, earnings are also of low quality.

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

J.K. SHAH CLASSES a Veranda Enterprise

27. Which of the following actions is least likely to increase earnings for the current period?
    (A) Decreasing the salvage value of depreciable assets.
    (B) Recognizing revenue before fulfilling the terms of a sale.
    (C) Selling more inventory than is purchased or produced.

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