

Chapter 02 Financial Reporting and Analysis

Student: _____

1. Which of the following would require the filing of Form 8-K?

I. Major acquisition
II. Audited financial statements
III. Bankruptcy
IV. Change in management control

A.
B.
C.
D.
2. Which of the following is considered part of GAAP?

A.
B.
C.
D.
3. Which of the following is not considered a monitoring mechanism?

A.
B.
C.
D.
4. Which of the following statements about directors of a company is *true*?

A.
B.
C.
D.

5. Which of the following statements about accruals is true?
- A.
 - B.
 - C.
 - D.
6. Which of the following statements about cash flows is true?
- A.
 - B.
 - C.
 - D.
7. Relevance, one of the desirable qualities of accounting information, implies:
- A.
 - B.
 - C.
 - D.
8. Financial accounting data has some inherent limitations to investors. Which of the following is a limitation?
- I. Not all economic events are easily quantifiable.
 - II. Many accounting entries rely heavily on estimates.
 - III. Historical costs do not accurately reflect the true value of firms.
 - IV. Inflation can distort analysis of accounting data.
- A.
 - B.
 - C.
 - D.

9. If a company fails to record a material amount of depreciation in a previous year, this is considered:
- A.
 - B.
 - C.
 - D.
10. Which of the following is an example of judgments made in the accounting reporting process?
- I. Useful life of machinery
 - II. Allowance for doubtful accounts
 - III. Obsolescence of assets
 - IV. Interest payment on bonds
- A.
 - B.
 - C.
 - D.
11. Which of the following would affect the comparability of accounting information for a given company from one accounting period to the next?
- I. Change in accounting principles
 - II. Disposition of segment of business
 - III. Restructuring expenses
 - IV. Change in auditors
- A.
 - B.
 - C.
 - D.

12. Which of the following would affect the comparison of financial statements across two different firms?
- I. Different accounting principles
 - II. Different sizes of the companies
 - III. Different reporting periods
 - IV. Different industries

- A.
- B.
- C.
- D.

Byfort Company reports the following in its financial statements:

	<u>2005</u>	
Accounts receivable, net	\$ 34,289	\$
Net sales*	\$360,007	\$

*All sales are on credit.

13. How much did the company collect in cash from customers during 2006?

- A.
- B.
- C.
- D.

14. How much sales would have been reported by the company in 2006 if Byfort used cash accounting and not accrual accounting?

- A.
- B.
- C.
- D.

15. 10-K reports are:
- A.
 - B.
 - C.
 - D.
16. The management of Finner Company believes that "the statement of cash flows is not a very useful statement" and does not include it with the company's financial statements. As a result the auditor's opinion should be:
- A.
 - B.
 - C.
 - D.
17. Which of the following statements is incorrect?
- A.
 - B.
 - C.
 - D.
18. When analyzing financial statements, it is important to recognize that accounting distortions can arise. Accounting distortions are those things that cause deviations in accounting information from the underlying economics. Which of the following statements is not correct?
- A.
 - B.
 - C.
 - D.

19. Which of the following is a change in an accounting estimate?
- I. A change from straight-line depreciation to declining balance method
 - II. A change in estimated salvage value of depreciable asset
 - III. A change in estimated useful life of an asset
 - IV. Recording depreciation for the first time on machinery purchased five years ago
- A.
B.
C.
D.
20. Which of the following is a change in accounting principle?
- I. A change from LIFO to FIFO
 - II. A change in estimated salvage value of depreciable asset
 - III. A change from an accelerated depreciation method to straight-line depreciation
 - IV. Recording depreciation for the first time on machinery purchased five years ago
- A.
B.
C.
D.
21. Which of the following is not a source of industry information?
- A.
B.
C.
D.
22. Which of the following information would not be filed with the SEC by a publicly traded company?
- A.
B.
C.
D.

23. Accounting standards are:
- A.
 - B.
 - C.
 - D.
24. The matching principle requires that:
- A.
 - B.
 - C.
 - D.
25. Which of the following is required to be filed with the SEC, if a company changes its auditors?
- A.
 - B.
 - C.
 - D.
26. The primary responsibility for fair and accurate financial reporting rests with the:
- A.
 - B.
 - C.
 - D.
27. Which of the following is *incorrect*? When using the 10-Q, the analyst should be aware that the usefulness of the quarterly financial statements might be affected by:
- A.
 - B.
 - C.
 - D.

28. Voluntary disclosure by managers is becoming an increasingly important source of information. Which of the following is *least likely* to be a reason for this increased disclosure?
- A.
 - B.
 - C.
 - D.
29. _____ are *secondary* qualities of accounting information that make it useful for decision making.
- A.
 - B.
 - C.
 - D.
30. Economic income measures change in:
- A.
 - B.
 - C.
 - D.
31. Which one of the following is *not* an example of a red flag to one should be aware of when evaluating earnings quality?
- A.
 - B.
 - C.
 - D.
32. Economic income includes:
- A.
 - B.
 - C.
 - D.

33. For a going concern, company value can be expressed by:
- A.
 - B.
 - C.
 - D.
34. Accounting income consists of all the following components except:
- A.
 - B.
 - C.
 - D.
35. To determine a company's sustainable earning power, an analyst needs to first determine the recurring component of the current period's accounting income by excluding nonrecurring components of accounting income. Such adjusted earnings are often referred to as:
- A.
 - B.
 - C.
 - D.
36. SFAS 157 defines fair value as the:
- A.
 - B.
 - C.
 - D.
37. SFAS prescribes that information about the level of inputs used for determining fair values must be reported in the:
- A.
 - B.
 - C.
 - D.

38. All of the following are basic approaches to valuation except:
- A.
 - B.
 - C.
 - D.
39. GAAP stands for General American Accounting Principles, and must be adhered to by publicly traded companies when preparing their financial statements.
- True False
40. FASB stands for Financial Accounting Service Bureau, and is a sub-division of the Securities and Exchange Commission (SEC).
- True False
41. Under GAAP accounting, a company has the choice of using cash or accrual accounting in preparing its financial statements.
- True False
42. Under cash accounting, a company must recognize revenues in financial statements when the revenues are earned or realized.
- True False
43. Under accrual accounting, a company will recognize expenses as they are paid.
- True False
44. Accrual income is a better predictor of future cash flows than current cash flows.
- True False
45. External auditors provide "reasonable", as opposed to "absolute" assurance that the financial statements provide no material misstatement.
- True False

46. Net income is usually higher than free cash flows.
- True False
47. By using earnings management, managers always try to increase income.
- True False
48. Income smoothing is a form of earnings management.
- True False
49. Income shifting is not one of the earnings management mechanics.
- True False
50. The development of the financial statements is management's responsibility, and the auditor is not concerned with the process of development.
- True False
51. Accounting information is "material" if its omission would cause a reasonable person to make a different decision if the information was included.
- True False
52. Accounting distortions arise from the nature of accrual accounting.
- True False
53. Primary responsibility for fair and accurate financial statements rests with the auditors.
- True False
54. Audits are designed and implemented with the objective of detecting fraud.
- True False
55. Accounting standards issued by the SEC are applicable to all US companies being audited.
- True False

56. The "big bath" strategy is often used in conjunction with an income-increasing strategy for other years.
- True False
57. Accounting standards are set by the American Institute of Certified Public Accountants (AICPA).
- True False
58. The Securities and Exchange Commission (SEC) has the power to issue accounting standards, but generally defers this responsibility to the Financial Accounting Standards Board (FASB).
- True False
59. Accrual accounting overcomes both the timing and the matching problems that are inherent in cash accounting.
- True False
60. FASB has recognized the conceptual superiority of the historical value concept and has, in principle, decided to eventually move to a model where all asset and liability values are recorded at fair value.
- True False
61. Accounting or reported income is same as economic income.
- True False
62. Operating income is often referred to as net operating profit before tax.
- True False
63. Accounting income attempts to capture elements of both permanent income and economic income, but with measurement error.
- True False

64. Operating earnings includes all revenue and expense components that pertain to the company's operating business, regardless of whether they are recurring or nonrecurring.

True False

65. Under the fair value model, income is determined by matching costs to recognized revenues, which have to be realized and earned.

True False

66. The fair value of an asset is the hypothetical price at which a business can sell the asset (exit price).

True False

67. **Motivation to Manipulate Financial Results**

There are many ways in which the management of a company can manage the reported earnings. Give three reasons why management may want to manage earnings being sure to explain your answer in full.

68.

Earnings Management

Earnings management can be defined as the "purposeful intervention by management in the earnings process, usually to satisfy selfish objectives" (Schipper, 1989).

Earnings management techniques can be separated into those that are "cosmetic" (without cash flow consequences) and those that are "real" (with cash flow consequences).

The management of a company wishes to increase earnings this period.

List three "cosmetic" and three "real" techniques that can be used to achieve this objective and explain why they will achieve the objective.

69.

Identifying red flags

One step in assessing the quality of earnings is to look for red flags. An example of a red flag is a significant increase in accounts receivable without commensurate growth in sales (that is, accounts receivable turnover decreases). List five other red flags an astute analyst might look for. Also, provide the reason for it being a red flag, and identify where the analyst might find this information.

70.

Discretionary Expenditures

Discretionary expenditures are outlays that management can vary across periods to conserve resources and/or manage earnings. Give three examples and explain their potential impact on earnings quality when analyzing a company.

71.

Balance Sheet Analysis of Earnings Quality

The relevance of reported asset values is linked (with few exceptions like cash, held-to-maturity investments, and land) with their ultimate recognition as reported expenses. Provisions and liability values on the balance sheet may also affect earnings quality. For each of the following give an example and explain its impact upon cumulative earnings.

- a. An overstated asset
- b. An understated asset
- c. An overstated liability or provision
- d. An understated liability or provision

Fair Value Accounting

ABC Co. starts its business raising \$110,000 in cash; \$60,000 from issuing equity and \$50,000 from issuing 6% bonds at par. ABC used the whole amount of cash to buy a building, which it rents out for \$10,000 per year. Given below is the opening balance sheet of ABC Co. for the first year of operations.

	Year 1
<u>Assets</u>	
Cash	\$ 0
Building	110,000
	110,000
<u>Liabilities and Shareholder's equity</u>	
Long-term debt	50,000
Shareholders' equity	60,000
	110,000

At the end of Year 1, the building is valued at \$150,000. Also, the market value of bonds has fallen to \$49,000. Assume the useful life of the building is 30 years, and its salvage value is \$50,000 at the end of that period. The rental income is received on the last day of the year. Interest on bonds is also paid on this day.

Prepare the year-end balance sheet and income statement of ABC Co. based on *Fair value*. Compare the historical and fair values at year-end.

Chapter 02 Financial Reporting and Analysis **Key**

1. Which of the following would require the filing of Form 8-K?

- I. Major acquisition
- II. Audited financial statements
- III. Bankruptcy
- IV. Change in management control

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #1

2. Which of the following is considered part of GAAP?

- A.**
- B.
- C.
- D.

Subramanyam - Chapter 02 #2

3. Which of the following is not considered a monitoring mechanism?

- A.
- B.**
- C.
- D.

Subramanyam - Chapter 02 #3

4. Which of the following statements about directors of a company is *true*?

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #4

5. Which of the following statements about accruals is true?

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #5

6. Which of the following statements about cash flows is true?

- A.
- B.
- C.
- D.**

Subramanyam - Chapter 02 #6

7. Relevance, one of the desirable qualities of accounting information, implies:

- A.
- B.**
- C.
- D.

Subramanyam - Chapter 02 #7

8. Financial accounting data has some inherent limitations to investors. Which of the following is a limitation?

- I. Not all economic events are easily quantifiable.
- II. Many accounting entries rely heavily on estimates.
- III. Historical costs do not accurately reflect the true value of firms.
- IV. Inflation can distort analysis of accounting data.

- A.
- B.
- C.
- D.**

Subramanyam - Chapter 02 #8

9. If a company fails to record a material amount of depreciation in a previous year, this is considered:

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #9

10. Which of the following is an example of judgments made in the accounting reporting process?

- I. Useful life of machinery
- II. Allowance for doubtful accounts
- III. Obsolescence of assets
- IV. Interest payment on bonds

- A.
- B.**
- C.
- D.

Subramanyam - Chapter 02 #10

11. Which of the following would affect the comparability of accounting information for a given company from one accounting period to the next?

- I. Change in accounting principles
- II. Disposition of segment of business
- III. Restructuring expenses
- IV. Change in auditors

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #11

12. Which of the following would affect the comparison of financial statements across two different firms?
- I. Different accounting principles
 - II. Different sizes of the companies
 - III. Different reporting periods
 - IV. Different industries

A.
B.
C.
D.

Subramanyam - Chapter 02 #12

Byfort Company reports the following in its financial statements:

	<u>2005</u>	
Accounts receivable, net	\$ 34,289	\$
Net sales*	\$360,007	\$

*All sales are on credit.

Subramanyam - Chapter 02

13. How much did the company collect in cash from customers during 2006?

A.
B.
C.
D.

Subramanyam - Chapter 02 #13

14. How much sales would have been reported by the company in 2006 if Byfort used cash accounting and not accrual accounting?

A.
B.
C.
D.

Subramanyam - Chapter 02 #14

15.

10-K reports are:

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #15

16.

The management of Finner Company believes that "the statement of cash flows is not a very useful statement" and does not include it with the company's financial statements. As a result the auditor's opinion should be:

- A.**
- B.
- C.
- D.

Subramanyam - Chapter 02 #16

17.

Which of the following statements is incorrect?

- A.
- B.**
- C.
- D.

Subramanyam - Chapter 02 #17

18.

When analyzing financial statements, it is important to recognize that accounting distortions can arise. Accounting distortions are those things that cause deviations in accounting information from the underlying economics. Which of the following statements is not correct?

- A.
- B.
- C.
- D.**

Subramanyam - Chapter 02 #18

19.

Which of the following is a change in an accounting estimate?

- I. A change from straight-line depreciation to declining balance method
- II. A change in estimated salvage value of depreciable asset
- III. A change in estimated useful life of an asset
- IV. Recording depreciation for the first time on machinery purchased five years ago

- A.
- B.
- C.
- D.**

Subramanyam - Chapter 02 #19

20.

Which of the following is a change in accounting principle?

- I. A change from LIFO to FIFO
- II. A change in estimated salvage value of depreciable asset
- III. A change from an accelerated depreciation method to straight-line depreciation
- IV. Recording depreciation for the first time on machinery purchased five years ago

- A.
- B.
- C.
- D.**

Subramanyam - Chapter 02 #20

21.

Which of the following is not a source of industry information?

- A.**
- B.
- C.
- D.

Subramanyam - Chapter 02 #21

22. Which of the following information would not be filed with the SEC by a publicly traded company?

- A.
- B.
- C.
- D.**

Subramanyam - Chapter 02 #22

23. Accounting standards are:

- A.**
- B.
- C.
- D.

Subramanyam - Chapter 02 #23

24. The matching principle requires that:

- A.**
- B.
- C.
- D.

Subramanyam - Chapter 02 #24

25. Which of the following is required to be filed with the SEC, if a company changes its auditors?

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #25

26. The primary responsibility for fair and accurate financial reporting rests with the:

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #26

27. Which of the following is *incorrect*? When using the 10-Q, the analyst should be aware that the usefulness of the quarterly financial statements might be affected by:

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #27

28. Voluntary disclosure by managers is becoming an increasingly important source of information. Which of the following is *least likely* to be a reason for this increased disclosure?

- A.
- B.
- C.
- D.**

Subramanyam - Chapter 02 #28

29. _____ are *secondary* qualities of accounting information that make it useful for decision making.

- A.**
- B.
- C.
- D.

Subramanyam - Chapter 02 #29

30. Economic income measures change in:

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #30

31. Which one of the following is *not* an example of a red flag to one should be aware of when evaluating earnings quality?

- A.
- B.**
- C.
- D.

Subramanyam - Chapter 02 #31

32. Economic income includes:

- A.
- B.
- C.**
- D.

Subramanyam - Chapter 02 #32

33. For a going concern, company value can be expressed by:

- A.**
- B.
- C.
- D.

Subramanyam - Chapter 02 #33

34. Accounting income consists of all the following components except:

- A.
- B.
- C.
- D.**

Subramanyam - Chapter 02 #34

35. To determine a company's sustainable earning power, an analyst needs to first determine the recurring component of the current period's accounting income by excluding nonrecurring components of accounting income. Such adjusted earnings are often referred to as:

- A.
- B.
- C.
- D.

Subramanyam - Chapter 02 #35

36. SFAS 157 defines fair value as the:

- A.
- B.
- C.
- D.

Subramanyam - Chapter 02 #36

37. SFAS prescribes that information about the level of inputs used for determining fair values must be reported in the:

- A.
- B.
- C.
- D.

Subramanyam - Chapter 02 #37

38. All of the following are basic approaches to valuation except:

- A.
- B.
- C.
- D.

Subramanyam - Chapter 02 #38

39. GAAP stands for General American Accounting Principles, and must be adhered to by publicly traded companies when preparing their financial statements.

FALSE

Subramanyam - Chapter 02 #39

40. FASB stands for Financial Accounting Service Bureau, and is a sub-division of the Securities and Exchange Commission (SEC).

FALSE

Subramanyam - Chapter 02 #40

41. Under GAAP accounting, a company has the choice of using cash or accrual accounting in preparing its financial statements.

FALSE

Subramanyam - Chapter 02 #41

42. Under cash accounting, a company must recognize revenues in financial statements when the revenues are earned or realized.

FALSE

Subramanyam - Chapter 02 #42

43. Under accrual accounting, a company will recognize expenses as they are paid.

FALSE

Subramanyam - Chapter 02 #43

44. Accrual income is a better predictor of future cash flows than current cash flows.

TRUE

Subramanyam - Chapter 02 #44

45. External auditors provide "reasonable", as opposed to "absolute" assurance that the financial statements provide no material misstatement.

TRUE

Subramanyam - Chapter 02 #45

46. Net income is usually higher than free cash flows.

TRUE

Subramanyam - Chapter 02 #46

47. By using earnings management, managers always try to increase income.

FALSE

Subramanyam - Chapter 02 #47

48. Income smoothing is a form of earnings management.

TRUE

Subramanyam - Chapter 02 #48

49. Income shifting is not one of the earnings management mechanics.

FALSE

Subramanyam - Chapter 02 #49

50. The development of the financial statements is management's responsibility, and the auditor is not concerned with the process of development.

FALSE

Subramanyam - Chapter 02 #50

51. Accounting information is "material" if its omission would cause a reasonable person to make a different decision if the information was included.

TRUE

Subramanyam - Chapter 02 #51

52. Accounting distortions arise from the nature of accrual accounting.

TRUE

Subramanyam - Chapter 02 #52

53. Primary responsibility for fair and accurate financial statements rests with the auditors.

FALSE

Subramanyam - Chapter 02 #53

54. Audits are designed and implemented with the objective of detecting fraud.

FALSE

Subramanyam - Chapter 02 #54

55. Accounting standards issued by the SEC are applicable to all US companies being audited.

FALSE

Subramanyam - Chapter 02 #55

56. The "big bath" strategy is often used in conjunction with an income-increasing strategy for other years.

TRUE

Subramanyam - Chapter 02 #56

57. Accounting standards are set by the American Institute of Certified Public Accountants (AICPA).

FALSE

Subramanyam - Chapter 02 #57

58. The Securities and Exchange Commission (SEC) has the power to issue accounting standards, but generally defers this responsibility to the Financial Accounting Standards Board (FASB).

TRUE

Subramanyam - Chapter 02 #58

59. Accrual accounting overcomes both the timing and the matching problems that are inherent in cash accounting.

TRUE

Subramanyam - Chapter 02 #59

60. FASB has recognized the conceptual superiority of the historical value concept and has, in principle, decided to eventually move to a model where all asset and liability values are recorded at fair value.

FALSE

Subramanyam - Chapter 02 #60

61. Accounting or reported income is same as economic income.

FALSE

Subramanyam - Chapter 02 #61

62. Operating income is often referred to as net operating profit before tax.

FALSE

Subramanyam - Chapter 02 #62

63. Accounting income attempts to capture elements of both permanent income and economic income, but with measurement error.

TRUE

Subramanyam - Chapter 02 #63

64. Operating earnings includes all revenue and expense components that pertain to the company's operating business, regardless of whether they are recurring or nonrecurring.

TRUE

Subramanyam - Chapter 02 #64

65. Under the fair value model, income is determined by matching costs to recognized revenues, which have to be realized and earned.

FALSE

Subramanyam - Chapter 02 #65

66. The fair value of an asset is the hypothetical price at which a business can sell the asset (exit price).

TRUE

Subramanyam - Chapter 02 #66

Motivation to Manipulate Financial Results

There are many ways in which the management of a company can manage the reported earnings. Give three reasons why management may want to manage earnings being sure to explain your answer in full.

(a) Contracting incentives:

Many contracts use accounting numbers. Management compensation contracts may have a bonus formula based upon earnings and other metrics. Management may have an incentive to boost earnings in order to reach a specified target. If real earnings exceed the formula limits, the management has an incentive to reduce earnings, banking the extra income for the following year(s).

Other contracts will also create incentives for earnings management. Management may stretch earnings in order to avoid violating a debt covenant.

(b) Stock price effects:

Higher stock prices benefit executives with stock options.

Higher prices are useful for acquisitions and security offerings.

Smooth earnings growth and beating market expectations each quarter are important objectives when managing earnings. They reduce the market's perception of risk and decrease the company's cost of capital.

Suppliers and customers like dealing with a successful company.

(c) Other incentives:

Reduced earnings may be useful for regulatory and political purposes. For example, a utility company showing lower earnings might have a stronger case when seeking rate increase approvals from a regulatory authority. Or a steel company could exaggerate the effect of cheap

foreign imports when requesting tariff protection.

Reduced earnings aid management when confronting labor union demands.

Use of a big bath write-off by a new management team clears the way for future earnings increases and signals to the market that the new team is making the tough decisions.

Earnings Management

Earnings management can be defined as the "purposeful intervention by management in the earnings process, usually to satisfy selfish objectives" (Schipper, 1989).

Earnings management techniques can be separated into those that are "cosmetic" (without cash flow consequences) and those that are "real" (with cash flow consequences).

The management of a company wishes to increase earnings this period.

List three "cosmetic" and three "real" techniques that can be used to achieve this objective and explain why they will achieve the objective.

Cosmetic (non-cash flow) techniques would be:

- Decrease estimated bad debt expense
- Decrease estimated warranty expense
- Increase in estimated salvage value of depreciable assets
- Increase discount rate on pension plans
- Increase expected rate of return on pension assets
- Change from accelerated depreciation to straight line depreciation
- Capitalize expenses such as software development and R&D

Real changes would be:

- Decrease R&D expenditures
- Decrease advertising expenditures
- Decrease maintenance spending
- Changing accounting principle from LIFO to FIFO (assuming rising prices). Note that this will have a tax effect, as one cannot use FIFO for financial reporting purposes and LIFO for tax purposes.
- Channel loading (i.e. borrowing sales from the next period, which if repeated usually escalates in future periods)

Identifying red flags

One step in assessing the quality of earnings is to look for red flags. An example of a red flag is a significant increase in accounts receivable without commensurate growth in sales (that is, accounts receivable turnover decreases). List five other red flags an astute analyst might look for. Also, provide the reason for it being a red flag, and identify where the analyst might find this information.

Possible red flags

1. Decrease in inventory turnover - calculated from financial statements. This may indicate obsolete or unsalable goods.
2. Change in auditors - A parting of the ways with auditors may be because of disagreements over accounting matters. This will be filed in an 8-K report.
3. Qualified audit report
4. Frequent changes in accounting principles - this may be an attempt at earnings management and information can be found in auditor's letter and footnotes.
5. Reported net income is consistently higher than operating cash flow. Unless the company is growing fast for long periods this may indicate inflated earnings.
6. Reported net income is consistently higher than taxable income. Taxable income is not reported but we can infer whether it is higher or lower and by how much from the size of the deferred taxes. Consistently large deferred tax liabilities could be a signal of red flags.
7. Poor financial performance - Desperate companies are prone to desperate means and their managements are subject to temptation.
8. Frequent one-time charges and big baths - These may indicate significant underlying problems.
9. Significant and/or frequent changes in corporate management - Departures of officers and directors may be indicative of important corporate issues. The proxy, press releases, business publications and 8-K filings may contain this information.
10. Use of financing mechanisms - Off balance sheet financings such as operating leases, securitization of assets, special purpose entities,

etc. may be proper but can also be used to excess or to cover cash shortfalls. Footnotes and the MD&A should describe these situations.

11. Related party transactions and relationships - Unusual transactions (if disclosed) between management and the company (such as Adelphia Communications' guarantee of loans to the controlling Rigas family and Worldcom's extension of loans to its CEO Bernie Ebbers) indicate conflicts of interest, potential for abuses and self dealing, often prefacing financial difficulties for the company. Similarly, a board of directors with few independent directors is less likely to protect the interests of outside shareholders. The proxy statement is a particularly good place to catch these disclosures.

12. Incomprehensible disclosures - Some disclosures are so convoluted that it is just impossible to make heads or tails out of them. Looking back, with the benefit of hindsight, Enron's SPE disclosures contained interesting clues and warning signs. Increasingly, companies take pains to clearly explain complex situations so that the reader may take some comfort.

13. Last minute transactions - Transactions that take place at the end of the reporting period may be used to make up for the poor results that would otherwise have been achieved.

Discretionary Expenditures

Discretionary expenditures are outlays that management can vary across periods to conserve resources and/or manage earnings. Give three examples and explain their potential impact on earnings quality when analyzing a company.

Advertising, selling, and marketing expense cutbacks can penalize future sales. In contrast, a huge new ad campaign or expansion of the sales force may benefit the following year.

R&D, while extremely difficult to evaluate, is generally considered important to future success, especially in high technology companies. There can be numerous successful research and development activities, but for each successful project, there can be countless failures. It is important to determine the amount of current research and development costs having future benefits.

Repairs and maintenance expenses, if insufficient, may lead to higher production costs or even the premature replacement of equipment.

Expenditure on training and managerial development programs are other discretionary future-directed outlays.

Balance Sheet Analysis of Earnings Quality

The relevance of reported asset values is linked (with few exceptions like cash, held-to-maturity investments, and land) with their ultimate recognition as reported expenses. Provisions and liability values on the balance sheet may also affect earnings quality. For each of the following give an example and explain its impact upon cumulative earnings.

- a. An overstated asset
- b. An understated asset
- c. An overstated liability or provision
- d. An understated liability or provision

- a. When an asset is overstated, earnings are overstated. Examples: The delay in recognizing impaired assets, such as obsolete inventories or unproductive plant and equipment and understatement of allowance for uncollectible accounts receivable.
- b. When an asset is understated, earnings are understated. Examples: Unrecognized appreciation on an acquired business that is recorded at original purchase price, excessive depreciation or amortization (short life or low salvage value).
- c. When a liability or provision is overstated, earnings are understated. Examples: Overestimation of severance costs for a planned restructuring.
- d. When a liability or provision is understated, earnings are overstated. Examples: Understatements in provisions for product warranties, environmental liabilities, subscription liabilities.

Fair Value Accounting

ABC Co. starts its business raising \$110,000 in cash; \$60,000 from issuing equity and \$50,000 from issuing 6% bonds at par. ABC used the whole amount of cash to buy a building, which it rents out for \$10,000 per year. Given below is the opening balance sheet of ABC Co. for the first year of operations.

	Year 1
<u>Assets</u>	
Cash	\$ 0
Building	110,000
	110,000
<u>Liabilities and Shareholder's equity</u>	
Long-term debt	50,000
Shareholders' equity	60,000
	110,000

At the end of Year 1, the building is valued at \$150,000. Also, the market value of bonds has fallen to \$49,000. Assume the useful life of the building is 30 years, and its salvage value is \$50,000 at the end of that period. The rental income is received on the last day of the year. Interest on bonds is also paid on this day.

Prepare the year-end balance sheet and income statement of ABC Co. based on *Fair value*. Compare the historical and fair values at year-end.

	Historical cost
<u>Assets</u>	
Cash*	\$ 7,000
Building	108,000
	\$ 115,000
<u>Liabilities and Shareholder's equity</u>	
Long-term debt	\$ 50,000
Shareholders' equity	65,000
	\$ 115,000
<u>Income Statement</u>	
Rental income	\$ 10,000
Depreciation	(2,000)
Interest expense	(3,000)
Unrealized gain/loss on condo	
Unrealized gain/loss on debt	
Net income	\$ 5,000

Rental income received	\$10,000
Interest paid on bonds	3,000
Cash in hand	7,000

$$\begin{aligned}
 \text{Depreciation on building} &= \frac{\text{Cost} - \text{Salvage value}}{\text{Number of years}} \\
 &= \frac{\$110,000 - \$50,000}{30} \\
 &= \$2,000
 \end{aligned}$$

Notice that under fair value method, all assets and liabilities are considered at their market value. Fair value accounting does not consider any depreciation on fixed assets. It recognizes any unrealized gain or loss on assets or long-term debt on account of change in market value.

Chapter 02 Financial Reporting and Analysis **Summary**