

LO.a: Demonstrate the use of a conceptual framework for assessing the quality of a company's financial reports.

1. Company ABC's financial statements adhere to generally accepted accounting principles (GAAP). However, ABC understates earnings in periods when the company is performing well and overstates earnings in periods when the company is struggling. Based on this information ABC's financial statements can be best categorized as:
 - A. Non-GAAP compliant.
 - B. GAAP compliant, but with earnings management.
 - C. GAAP compliant and decision useful with sustainable and adequate returns.

LO.b: Explain potential problems that affect the quality of financial reports.

2. Which of the following is *least likely* an effect of an aggressive, premature and fictitious revenue recognition accounting choice?
 - A. Overstated income.
 - B. Understated assets.
 - C. Overstated equity.

LO.c: Describe how to evaluate the quality of a company's financial reports.**LO.d: Evaluate the quality of a company's financial reports.**

3. Analyst 1: Lower M-scores indicate an increased probability of earnings manipulation.
Analyst 2: A GMI value greater than 1 indicates deteriorating gross margins.
 - A. Analyst 1 is correct.
 - B. Analyst 2 is correct.
 - C. Both analysts are correct.

LO.e: Describe the concept of sustainable (persistent) earnings.

4. Sustainable earnings refer to earnings that are:
 - A. Likely to persist in future
 - B. Likely to have higher growth than competitors
 - C. Likely to be affected by business financing decisions

LO.f: Describe indicators of earnings quality.

5. Analyst 1: Earnings that have a significant accrual component are less persistent.
Analyst 2: Low-quality earnings are insufficient to cover the company's cost of capital and/or are derived from nonrecurring, one-off activities.
 - A. Analyst 1 is correct.
 - B. Analyst 2 is correct.
 - C. Both analysts are correct.

LO.g: Explain mean reversion in earnings and how the accruals component of earnings affects the speed of mean reversion.

6. When earnings are largely comprised of accruals, mean reversion will occur:
- A. relatively faster than usual.
 - B. relatively slower than usual.
 - C. at the same rate as usual.

LO.h: Evaluate the earnings quality of a company.

7. Which of the following statements about the earnings quality of a company is *least* accurate?
- A. The objective of analyzing earnings is to understand the persistence and sustainability of earnings
 - B. Bankruptcy prediction models are used to quantify the likelihood that a company will default on its debt and/or declare bankruptcy.
 - C. The higher the Z-score, the higher the probability of bankruptcy of a company.

LO.i: Describe indicators of cash flow quality.

LO.j: Evaluate the cash flow quality of a company.

8. Which of the following *most likely* indicates that a company is boosting its operating cash flow by selling receivables to a third party?
- A. A decrease in the company's days' sales outstanding.
 - B. An increase in the company's days' sales outstanding.
 - C. An increase in a company's days of payable.

LO.k: Describe indicators of balance sheet quality.

LO.l: Evaluate the balance sheet quality of a company.

9. Which of the following characteristic of high financial reporting quality with regard to the balance sheet, is *most likely* affected by the presence of off-balance items such as operating leases, purchase contracts?
- A. Completeness.
 - B. Unbiased measurement.
 - C. Clear presentation.

LO.m: Describe sources of information about risk.

10. Statement 1: Audit opinions are based on historical information and typically do not provide information on a timely enough basis to be a useful source of information about risk.
Statement 2: A change in the auditor, especially multiple changes in the auditor, can be a signal of possible reporting problems.
- A. Only statement 1 is correct.
 - B. Only statement 2 is correct.

C. Both statements are correct.

Solutions

1. B is correct. ABC's financial statements are GAAP compliant but cannot be relied upon to assess earnings quality.
2. B is correct. An aggressive, premature and fictitious revenue recognition will result in overstated income and overstated equity.
3. B is correct. Higher M-scores indicate an increased probability of earnings manipulation.
4. A is correct. Sustainable earnings refer to earnings that can be expected to persist in the future.
5. C is correct. Both statements are correct.
6. A is correct. Earnings consist of cash flow and accruals and there is an inverse relationship between accruals and cash flow. When earnings are largely comprised of accruals, mean reversion will occur at a faster rate. The opposite is true when earnings are relatively free of accruals.
7. C is correct. The higher the Z-score, the lower the probability of bankruptcy of a company.
8. A is correct. A decrease in the company's days' sales outstanding may indicate that the company is boosting operating cash flow by selling receivables to a third party.
9. A is correct. Significant amounts of off-balance-sheet obligations lack completeness as they understate a company's leverage.
10. C is correct. Both statements are correct.