Financial Reporting and Analysis: Financial Reporting Quality and Financial Statement Analysis

Test ID: 7694279

Question #1 of 38

Question ID: 456304

A significant increase in days payables above historical levels is *most likely* associated with:

✓ **A)** **low quality of the cash flow statement.**

✗ **B)** an increase in net working capital.

✗ **C)** an unsustainable increase in reported earnings.

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.

Question #2 of 38

Question ID: 460648

If a firm's financial reports are of low quality, can users of the reports assess the quality of the firm's earnings?

✗ **A)** **Yes, because if financial reports are of low quality, earnings are also of low quality.**

✓ **B)** No, because low-quality financial reports are not useful for assessing the quality of earnings.

✗ **C)** Yes, because users can assess earnings quality independently of financial reporting quality.

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.

Question #3 of 38

Question ID: 460651

Aggressive accounting choices include:

✗ **A)** **decreasing the estimated useful life of an asset.**

✓ **B)** classifying interest paid as an investing cash flow.

✗ **C)** increasing the valuation allowance of a deferred tax asset.

Explanation

Aggressive accounting choices are those that increase earnings, operating cash flows, or asset values in the current period. Classifying interest paid as an investing cash flow, rather than as an operating cash flow, results in higher CFO and lower CFI. The other choices are examples of conservative accounting choices because they decrease earnings in the current period.

Question #4 of 38

Question ID: 414694

A firm recognizes a goodwill impairment in its most recent financial statement, reducing goodwill from $50 million to $40 million. How should an analyst *most appropriately* adjust this financial statement for goodwill when calculating financial ratios?

- ☓ **A) Make no adjustments to assets or earnings because both reflect the impairment.**
- ☓ **B)** Decrease earnings but make no adjustment to assets.
- ✓ **C)** Decrease assets and increase earnings.

Explanation

The recommended adjustment for goodwill before calculating financial ratios is to remove goodwill from the balance sheet (decreasing assets) and reverse any losses recognized due to goodwill impairment (increasing earnings).

Question #5 of 38

Question ID: 434322

LIFO ending inventory can be adjusted to a FIFO basis by:

- ☓ **A) adding the change in the LIFO reserve.**
- ☓ **B)** subtracting the change in the LIFO reserve.
- ✓ **C)** adding the LIFO reserve.

Explanation

LIFO ending inventory can be adjusted to a FIFO basis by adding the LIFO reserve, which a firm using LIFO must disclose in the notes to its financial statements.

Question #6 of 38

Question ID: 414684

An analyst makes the following two statements:
Statement #1 - From a lender's perspective, higher volatility of a borrower's profit margins is undesirable for floating-rate debt but not for fixed-rate debt.

Statement #2 - Product and geographic diversification should lower a borrower's credit risk.
With respect to these statements:

- ☓ **A) both are incorrect.**
- ☓ **B)** both are correct.
- ✓ **C)** only one is correct.

Explanation

Margin stability is desirable from the lender's perspective for both floating-rate and fixed-rate debt. Higher volatility will increase credit risk. Product and geographic diversification should lower credit risk as the borrower is less sensitive to adverse events and conditions.

Question #7 of 38

Question ID: 414692

Patch Grove Nursery uses the LIFO inventory accounting method. Maria Huff, president, wants to determine the financial statement impact of changing to the FIFO accounting method. Selected company information follows:

- Year-end inventory: $22,000
- LIFO reserve: $4,000
- Change in LIFO reserve: $1,000
- LIFO cost of goods sold: $18,000
- After-tax income: $2,000
- Tax rate: 40%

Under FIFO, the nursery's ending inventory and after-tax profit for the year would have been:

	FIFO ending inventory	FIFO after-tax profit
✗ **A)**	**$26,000**	**$1,400**
✓ **B)**	$26,000	$2,600
✗ **C)**	$18,000	$2,600

Explanation

FIFO ending inventory = LIFO ending inventory + LIFO reserve = 22,000 + 4,000 = $26,000

FIFO after-tax profit = LIFO after-tax profit + (change in LIFO reserve)(1 − t) = $2,000 + ($1,000)(1 − 0.4) = $2,000 + $600 = $2,600

Question #8 of 38

Question ID: 472415

For a publicly traded U.S. firm, which of the following profit measures would require reconciliation to U.S. GAAP if it appeared in the firm's financial statements? Income from continuing operations excluding:

- ✗ **A)** **discontinued operations.**
- ✗ **B)** extraordinary items.
- ✓ **C)** research and development.

Explanation

Income from continuing operations excluding research and development is a non-GAAP measure that would require reconciliation to a U.S. GAAP measure. Under U.S. GAAP, income from continuing operations is reported net of discontinued operations and extraordinary items.

Question #9 of 38

Question ID: 414688

An analyst screening potential equity investments to identify value stocks is *most likely* to exclude companies with:

- ✓ **A)** **high price-to-earnings ratios.**
- ✗ **B)** high dividend payout ratios.
- ✗ **C)** low earnings growth rates.

Explanation

Value stocks are considered to be those that have low prices relative to earnings (or relative to sales, cash flow, or book value). Screens that exclude firms with low earnings growth rates or high dividend payout ratios are more likely to be used to identify growth stocks.

Question #10 of 38

Question ID: 460650

With regard to the goal of neutrality in financial reporting, accounting standards related to research costs and litigation losses should be viewed as:

- ✗ **A)** **promoting neutral financial reporting.**
- ✓ **B)** biased toward conservative financial reporting.
- ✗ **C)** biased toward aggressive 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.

Question #11 of 38

Question ID: 414679

Sterling Company is a start-up technology firm that has been experiencing super-normal growth over the past two years. Selected common-size financial information follows:

	2007 Actual % of Sales	2008 Forecast % of Sales
Sales	100%	100%
Cost of goods sold	60%	55%
Selling and administration expenses	25%	20%
Depreciation expense	10%	10%
Net income	5%	15%
Non-cash operating working capital [a]	20%	25%

[a] Non-cash operating working capital = Receivables + Inventory - Payables

For the year ended 2007, Sterling reported sales of $20 million. Sterling expects that sales will increase 50% in 2008. Ignoring income taxes, what is Sterling's forecast operating cash flow for the year ended 2008, and is this forecast likely to be as reliable as a forecast for a large, well diversified, firm operating in mature industries?

	Operating cash flow	Reliable forecast
✗ **A)**	**$4.5 million**	**No**
✗ **B)**	$4.0 million	Yes
✓ **C)**	$4.0 million	No

Explanation

2008 sales are expected to be $30 million ($20 million 2007 sales × 1.5) and 2008 net income is expected to be $4.5 million ($30 million 2008 sales × 15%). 2007 non-cash operating working capital was $4 million ($20 million 2007 sales × 20%) and 2008 non-cash operating working capital is expected to be $7.5 million ($30 million 2008 sales × 25%). 2008 operating cash flow is expected to be $4 million ($4.5 million 2008 net income + $3 million 2008 depreciation - $3.5 million increase in non-cash operating working capital). Forecasts for small firms, start-ups, or firms operating in volatile industries may be less reliable than a forecast for a large, well diversified, firm operating in mature industries.

Question #12 of 38

Question ID: 460652

Management is *most likely* to be motivated to produce low-quality financial reports when:

✓ **A) earnings are less than analysts expect.**

✗ **B)** managers' compensation is unrelated to the firm's share price.

✗ **C)** the firm is not required to abide by loan covenants.

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.

Question #13 of 38

Question ID: 414687

Cody Scott would like to screen potential equity investments to identify value stocks and selects firms that have low price-to-sales ratios. Unfortunately, screening stocks based only on this criterion may result in stocks that have poor profitability or high financial leverage, which are undesirable to Scott. Which of the following filters could be added to the stock screen to *best* control for poor profitability and high financial leverage?
Filter #1 - Include only stocks with a debt-to-equity ratio that is above a certain benchmark value.

Filter #2 - Include only dividend paying stocks.
Filter #3 - Include only stocks with an assets-to-equity ratio that is below a certain benchmark value.

Filter #4 - Include only stocks with a positive return-on-equity.

	Poor profitability	High financial leverage
✗ **A)**	**Filter #4**	**Filter #3**
✗ **B)**	Filter #4	Filter #1
✓ **C)**	Filter #2	Filter #3

Explanation

Firms that have poor profitability are more likely to be non-dividend paying. Selecting only dividend paying stocks can serve as a check on poor profitability. Using positive ROE to control for poor performance can result in bogus results without additional filters. For example, if both the numerator (net income) and the denominator (average equity) are negative, ROE will be positive. The higher the assets-to-equity ratio, the higher the leverage. Selecting only stocks with an assets-to-equity ratio below a certain cut-off point will eliminate stocks with high leverage. Debt-to-equity above a certain point would include firms with higher, not lower, financial leverage.

Question #14 of 38

Question ID: 460653

Conditions that may cause firms to issue low-quality financial reports are *best* described as:

- ✗ **A)** **inappropriate ethical standards and failing to correct known reportable conditions.**
- ✓ **B)** opportunity, motivation, and rationalization.
- ✗ **C)** unstable organizational structure and deficient internal controls.

Explanation

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

Question #15 of 38

Question ID: 414678

According to the Management Discussion and Analysis section of Frankfurt Supply Company's annual report, Frankfurt recently decreased the sales prices of its products in order to increase market share. In addition, Frankfurt recently lowered its requirements for credit customers and increased the credit limits of some customers. If Frankfurt keeps its inventories unchanged, what is the *most likely* impact on Frankfurt's accounts receivable turnover and inventory turnover as a result of these changes?

- ✓ **A)** **Only one will decrease.**
- ✗ **B)** Both will increase.
- ✗ **C)** Both will decrease.

Explanation

Accounts receivable turnover will likely decrease as a result of offering credit to customers with weak credit histories. Collections will likely slow down and bad debt expense will likely increase. Inventory turnover is likely to increase as sales (and therefore COGS) increase from more liberal credit terms and the decrease in price.

Question #16 of 38

Question ID: 460649

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.

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).

Question #17 of 38

Question ID: 460654

Which of the following requirements are *most likely* to create incentives for management to manipulate earnings?

✗ **A) Disclosure regulations.**

✗ **B)** Audit requirements.

✓ **C)** 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.

Question #18 of 38

Question ID: 456303

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) Rationalization.**

✓ **B)** Motivation.

✗ **C)** Opportunity.

Explanation

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

Question #19 of 38

Question ID: 460655

Which of the following actions is *least likely* to increase earnings for the current period?

✗ **A) Recognizing revenue before fulfilling the terms of a sale.**

✗ **B)** Selling more inventory than is purchased or produced.

✓ **C)** 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.

Question #20 of 38

Question ID: 414653

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) capitalize leases.**

✗ **B)** understate assets.

✓ **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.

Question #21 of 38

Question ID: 460656

Under which inventory cost flow assumption is a firm *most likely* to show an unusual increase in gross profit margin by sales in excess of current period production?

✗ **A)** **FIFO.**

✓ **B)** LIFO.

✗ **C)** Average cost.

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.

Question #22 of 38

Question ID: 434318

In estimating pro forma cash flows for a company, analysts typically hold which of the following factors constant?

✓ **A)** **Noncash working capital as a percentage of sales.**

✗ **B)** Sales.

✗ **C)** Repayments of debt.

Explanation

To estimate pro forma cash flows, the analyst must make assumptions about future sources and uses of cash. The most important of these will be increases in working capital, capital expenditures on new fixed assets, issuance or repayments of debt, and issuance or repurchase of stock. A typical assumption is that noncash working capital will remain constant as a percentage of sales.

Question #23 of 38

Question ID: 434320

Other things equal, which of the following firm characteristics are most likely to be viewed favorably by credit rating agencies?

✓ **A)** **Large size, diverse product lines, many geographic regions.**

✗ **B)** Large size, diverse product lines, concentrated geographic regions.

✗ **C)** Small size, focused product lines, concentrated geographic regions.

Explanation

Other things equal, credit rating agencies tend to rate larger companies and those with diversified product lines and greater geographic diversification to be better credit risks.

Question #24 of 38

Question ID: 434319

Selected financial information gathered from Alpha Company and Omega Corporation follows:

	Alpha	Omega
Revenue	$1,650,000	$1,452,000
Earnings before interest, taxes, depreciation, and amortization	69,400	79,300
Quick assets	216,700	211,300
Average fixed assets	300,000	323,000
Current liabilities	361,000	404,400
Interest expense	44,000	58,100

Which of the following statements is *most* accurate?

✗ **A) Omega uses its fixed assets more efficiently than Alpha.**

✗ **B)** Alpha has a higher operating profit margin than Omega.

✓ **C)** Omega has lower interest coverage than Alpha.

Explanation

Using the EBITDA coverage ratio (EBITDA / Interest expense), Omega's EBITDA coverage is 1.4 ($79,300 EBITDA / $58,100 interest expense) and Alpha's EBITDA coverage is 1.6 ($69,400 EBITDA / $44,000 interest expense). Using EBITDA to measure operating profit, Alpha has a lower operating profit margin than Omega. Alpha's EBITDA margin is 4.2% ($69,400 EBITDA / $1,650,000 revenue) and Omega's EBITDA margin is 5.5% ($79,300 EBITDA / $1,452,000 revenue). Using fixed asset turnover to measure the efficiency of fixed assets, Omega uses its fixed assets less efficiently than Alpha. Alpha's fixed asset turnover is 5.5 ($1,650,000 revenue / $300,000 average fixed assets) and Omega's fixed asset turnover is 4.5 ($1,452,000 revenue / $323,000 average fixed assets).

Question #25 of 38

Question ID: 414685

When assessing credit risk, which of the following ratios would *best* measure a firm's tolerance for additional debt and a firm's operational efficiency?

Ratio #1 - Retained cash flow (CFO - dividends) divided by total debt.
Ratio #2 - Current assets divided by current liabilities.

Ratio #3 - Earnings before interest, taxes, depreciation, and amortization divided by revenues.

	Tolerance for leverage	Operational efficiency
✗ **A)**	**Ratio #2**	**Ratio #3**

✗ **B)** Ratio #3 Ratio #1

✓ **C)** Ratio #1 Ratio #3

Explanation

A firm's tolerance for additional debt can be measured by its capacity to repay debt. Retained cash flow divided by total debt is one of several measures that can be used. Operational efficiency refers to the firm's cost structure and can be measured by the "margin" ratios. EBITDA divided by sales is one version of an operating margin ratio. The current ratio is a measure of short-term liquidity.

Question #26 of 38

Question ID: 414682

For 2007, Morris Company had 73 days of inventory on hand. Morris would like to decrease its days of inventory on hand to 50. Morris' cost of goods sold for 2007 was $100 million. Morris expects cost of goods sold to be $124.1 million in 2008. Assuming a 365 day year, compute the impact on Morris' operating cash flow of the *change* in average inventory for 2008.

✓ **A) $3.0 million source of cash.**

✗ **B)** $3.0 million use of cash.

✗ **C)** $6.3 million source of cash.

Explanation

2007 inventory turnover was 5 (365 / 73 days in inventory). Given inventory turnover and COGS, 2007 average inventory was $20 million ($100 million COGS / 5 inventory turnover). 2008 inventory turnover is expected to be 7.3 (365 / 50 days in inventory). Given expected inventory turnover, 2008 average inventory is $17 million ($124.1 million COGS / 7.3 expected inventory turnover). To achieve 50 days of inventory on hand, average inventory must decline $3 million ($20 million 2007 average inventory - $17 million 2008 expected inventory). A decrease in inventory is a source of cash.

Question #27 of 38

Question ID: 472416

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)** asset turnover ratios.

✗ **C)** cash from operations.

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.

Question #28 of 38

Question ID: 441027

Falcon Financial Group is considering the purchase of Company A or Company B based on a low price-to-book investment strategy that also considers differences in solvency. Selected financial data for both firms, as of December 31, 20X7, follows:

in millions, except per-share data	Company A	Company B
Current assets	$3,000	$5,500
Fixed assets	$5,700	$5,500
Total debt	$2,700	$3,500
Common equity	$6,000	$7,500
Outstanding shares	500	750
Market price per share	$26.00	$22.50

The firms' financial statement footnotes contain the following:

- Company A values its inventory using the first in, first out (FIFO) method.
- Company B's inventory is based on the last in, first out (LIFO) method. Had Company B used FIFO, its inventory would have been $700 million higher.
- Company A leases its manufacturing plant. The remaining operating lease payments total $1,600 million. Discounted at 10%, the present value of the remaining payments is $1,000 million.
- Company B owns its manufacturing plant.

To make the firms financials ratios comparable, calculate the adjusted price-to-book ratios for Company A and Company B.

	Company A	Company B
✗ **A)**	**$1.63**	**$2.06**
✓ **B)**	$2.17	$2.06
✗ **C)**	$2.17	$2.81

Explanation

Company A should be adjusted for the operating lease liability and the related assets; however, adding the present value of the lease payments to both assets and liabilities does not change equity (book value). Thus, Company A's adjusted P/B ratio is 2.17 = [$26 price / ($6,000 million equity / 500 million shares)]. Company B's inventory should be adjusted back to FIFO by adding the LIFO reserve to both assets and equity. Thus, Company B's P/B ratio is 2.06 = $22.50 / [($7,500 million equity + $700 million LIFO reserve) / 750 million shares].

Question #29 of 38

Question ID: 414689

Comet Corporation is a capital intensive, growing firm. Comet operates in an inflationary environment and its inventory quantities are stable. Which of the following accounting methods will cause Comet to report a lower price-to-book ratio, all else equal?

	Inventory method	Depreciation method
✗ **A)**	**Last-in, First-out**	**Accelerated**
✗ **B)**	First-in, First-out	Accelerated
✓ **C)**	First-in, First-out	Straight-line

Explanation

FIFO results in higher assets and higher equity in an inflationary environment as compared to LIFO. Equity is higher because COGS is lower (and inventory higher) under FIFO. Straight-line depreciation will result in greater assets and equity compared to accelerated depreciation for a stable or growing firm. Equity is greater because depreciation expense is less with straight-line depreciation. Greater equity will result in greater book value per common share, the denominator of the price-to-book ratio. Greater book value per share will result in a lower price-to-book ratio.

Question #30 of 38

Question ID: 414681

Baetica Company reported the following selected financial statement data for the year ended December 31, 20X7:

in millions		% of Sales
For the year ended December 31, 20X7:	$500	100%
Sales		
Cost of goods sold	(300)	60%
Selling and administration expenses	(125)	25%
Depreciation	(50)	10%
Net income	$25	5%
As of December 31, 20X7:		
Non-cash operating working capital [a]	$100	20%
Cash balance	$35	N/A

[a] Non-cash operating working capital = Receivables + Inventory - Payables

Baetica expects that sales will increase 20% in 20X8. In addition, Baetica expects to make fixed capital expenditures of $75 million in 20X8. Ignoring taxes, calculate Baetica's expected cash balance, as of December 31, 2008, assuming all of the common-size percentages remain constant.

- ✗ **A) $80 million.**
- ✓ **B)** $30 million.
- ✗ **C)** $40 million.

Explanation

2008 sales are expected to be $600 million ($500 million 2007 sales × 1.2) and 20X8 net income is expected to be $30 million ($600 million 20X8 sales × 5%). 2008 non-cash operating working capital is expected to be $120 million ($600 million 20X8 sales × 20%). The change in cash is expected to be -$5 million ($30 million 20X8 net income + $60 million 20X8 depreciation - $20 million increase in non-cash operating working capital - $75 million 20X8 capital expenditures). The 20X8 ending balance of cash is expected to be $30 million ($35 million beginning cash balance - $5 million decrease in cash).

Question #31 of 38

Question ID: 414683

Jane Epworth, CFA, is preparing pro forma financial statements for Gavin Industries, a mature U.S. manufacturing firm with three distinct geographic divisions in the Midwest, South and West. Epworth prepares estimates of sales for each of Gavin's divisions using economists' estimates of next-period GDP growth and sums the three estimates to forecast Gavin's sales. Epworth's approach to estimating Gavin's sales is:

- ✗ **A) inappropriate, because sales should be forecast on a firm-wide basis and are unlikely to be related to GDP growth.**
- ✓ **B)** appropriate.
- ✗ **C)** inappropriate, because sales should be forecast on a firm-wide basis.

Explanation

Sales estimates can be more sophisticated than simply estimating a single growth rate. One common approach is to estimate the linear relationship between sales growth and economic growth and use this relationship to estimate sales growth based on economists' forecasts of GDP growth. Segment-by-segment analysis can also be applied, summing segment or division sales forecasts to produce an overall sales forecast for the firm.

Question #32 of 38

Question ID: 414680

Would projecting future financial performance based on past trends provide a reliable basis for valuation of the following firms?

Firm #1 - A rapidly growing company that has made numerous acquisitions and divestitures.
Firm #2 - A large, well-diversified, company operating in a number of mature industries.

	Firm #1	Firm #2
✗ **A)**	**No**	**No**
✓ **B)**	No	Yes
✗ **C)**	Yes	No

Explanation

Using past trends to project future financial performance would be reliable for a well-diversified firm operating in a number of mature industries. The diversified firm would likely have relatively predictable earnings. Using past trends to project future financial performance would not likely be reliable for the rapidly growing firm involved in numerous acquisitions and divestitures. Such a firm would likely have high earnings volatility.

Question #33 of 38

Question ID: 414656

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)** understate earnings.
- ✓ **C)** overstate earnings.

Explanation

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

Question #34 of 38

Question ID: 414691

At the end of 2007, Decatur Corporation reported last-in, first-out (LIFO) inventory of $20 million, cost of goods sold (COGS) of $64 million, and inventory purchases of $58 million. If the LIFO reserve was $6 million at the end of 2006 and $16 million at the end of 2007, compute first-in, first-out (FIFO) inventory at the end of 2007 and FIFO COGS for the year ended 2007.

	FIFO Inventory	FIFO COGS
✗ **A)**	**$36 million**	**$74 million**
✗ **B)**	$26 million	$54 million
✓ **C)**	$36 million	$54 million

Explanation

2007 FIFO inventory was $36 million ($20 million LIFO inventory + $16 million reserve). 2007 FIFO COGS was $54 million ($64 million LIFO COGS - $10 million increase in LIFO reserve).

Question #35 of 38

Question ID: 414693

To adjust for operating leases before calculating financial statement ratios, what value should an analyst add to a firm's liabilities?

✗ **A) Difference between present values of lease payments and the asset's future earnings.**

✗ **B)** Sum of future operating lease obligations.

✓ **C)** Present value of future operating lease payments.

Explanation

Before calculating ratios involving liabilities, an analyst should estimate the present value of operating lease obligations and add this value to the firm's liabilities.

Question #36 of 38

Question ID: 414677

National Scooter Company and Continental Chopper Company are motorcycle manufacturing companies. National's target market includes consumers that are switching to motorcycles because of the high cost of operating automobiles and they compete on price with other manufacturers. The average age of National's customers is 24 years.

Continental manufactures premium motorcycles and aftermarket accessories and competes on the basis of quality and innovative design. Continental is in the third year of a five-year project to develop a customized hybrid motorcycle. Which of the two firms would most likely report higher gross profit margin, and which firm would most likely report higher operating expense stated as a percentage of total cost?

	Higher gross profit margin	Higher percentage operating expense
✗ **A)**	**National**	**Continental**
✗ **B)**	Continental	National

✓ **C)** Continental

Continental

Explanation

Continental likely has the highest gross profit margin percentage since it is selling a customized product and does not compete primarily based on price. Because of the research and development costs of developing a new hybrid motorcycle, Continental likely has the higher operating expense stated as a percentage of total cost.

Question #37 of 38

Question ID: 434321

The price to tangible book value ratio subtracts what components from equity?

- ✗ **A) Goodwill and property, plant and equipment.**
- ✗ **B)** Intangible assets and property, plant and equipment.
- ✓ **C)** Goodwill and intangible assets.

Explanation

Price to tangible book value is calculated by removing goodwill and intangible assets from equity. This adjustment reduces assets and equity and produces a ratio that is not affected by differences in intangible asset values that may result from how the assets were acquired.

Question #38 of 38

Question ID: 434323

A firm that uses higher estimates of assets' useful lives or salvage values relative to its peers will report:

- ✗ **A) lower depreciation expense and lower net income.**
- ✓ **B)** lower depreciation expense and higher net income.
- ✗ **C)** higher depreciation expense and higher net income.

Explanation

Estimates of useful lives or salvage values that are too high will result in lower depreciation expense and higher net income.