Test Questions and Solutions

Chapter 1

True-False

1. A basic understanding of financial statements is needed due to ongoing financial turmoil and major corporate failures.

2. The SEC requires all companies, both public and private, to file annually a Form 10-K report.

3. Financial statements are currently prepared according to generally accepted accounting principles in the U.S.

4. The FASB was given Congressional authority to write accounting rules.

5. The goal of the International Accounting Standards Board is the adoption of uniform international accounting standards.

6. In 2006, the IASB and the FASB agreed to work on all major projects jointly.

7. Annual reports of public companies can only be found on the SEC's EDGAR database.

8. A corporate annual report contains three basic financial statements.

9. The notes to financial statements, while helpful, are not an integral part of the statements.

10. Management is responsible for the preparation of the financial statements, including the notes, and the auditor’s report attests to the fairness of the presentation.

11. The Sarbanes-Oxley Act eliminated the need for internal auditors.

12. An unqualified auditor's report states that the financial statements present fairly the financial position, results of operation, and the cash flows of the entity.

13. The Sarbanes-Oxley Act of 2002 requires all members of management as well as directors to certify the accuracy of the financial statements.

14. Despite the enactment of the Sarbanes-Oxley Act of 2002, corruption and unethical behavior continued in the 2000s.

15. The management discussion and analysis is of potential interest to the analyst because it contains information that cannot be found in the financial data.

16. The management discussion and analysis should contain a discussion of the commitments for capital expenditures, the purpose of such commitments, and expected sources of funding.

17. The shareholders' letter from the CEO of a firm offers factual information needed to analyze the financial statements.

18. The proxy statement offers information about such items as corporate governance, audit-related matters, directors and executive compensation, and related party transactions.

19. Publicity in the media can impact a firm’s financial performance.

20. Conglomerates operating in diversified lines of business are required to create separate annual reports for each line of business.

21. Accounting choices and estimates rarely have a significant impact on financial statement numbers.

22. The accrual basis of accounting means that revenues are recognized when the sale is made rather than when cash is received.

23. United States accounting rules have been perceived as being less complex than international standards.

24. The matching principle requires that expenses be matched with the generation of revenues in order to determine net income for an accounting period.

25. Examples of discretionary items include repairs and maintenance, research and development and advertising.

Multiple Choice

1. Which report is not required to be filed by public companies to the SEC?
    a. Annual reports (Form 10-K).
    b. Financial Reporting Rulings.
    c. A prospectus for any new security offering.
    d. Quarterly reports (From 10-Q).

2. The globalization of business activity has resulted in which of the following?
    a. Increased corruption and unethical behavior.
    b. A uniform set of accounting rules in all countries.
    c. The FASB and IASB working jointly on a project to converge accounting standards.
    d. The requirement that U.S. firms use international accounting rules as of 2006.

3. What basic financial statements can be found in a corporate annual report?
    a. Balance sheet, income statement, statement of shareholders' equity, and statement of cash flows.
    b. Balance sheet, auditor's report and income statement.
    c. Earnings statement and statement of retained earnings.
    d. Statement of cash flows and five-year summary of key financial data.

4. What information can be found on a balance sheet?
    a. Information to support that assets equal liabilities.
    b. The profit or loss for the accounting period.
    c. The reasons for changes in the cash account.
    d. The financial position on a particular date; i.e. assets, liabilities and shareholders' equity.

5. What information can be found on an income statement?
    a. The financing and investing activities during an accounting period.
    b. Cash inflows and cash outflows.
    c. A reconciliation of the beginning and ending balances of all revenue accounts.
    d. Revenues, expenditures, net profit or loss and net profit or loss per share.

6. What information can be found on a statement of stockholders' equity?
    a. A reconciliation of the cash account and the retained earnings account.
    b. A reconciliation of the beginning and ending balances of all accounts that appear in the stockholders' equity section of the balance sheet.
    c. A reconciliation of the operating, investing and financing activities of a firm.
    d. A reconciliation of net profit or loss and the cash account.

7. What item is not included in the notes to the financial statements?
    a. Details about inventory and property, plant and equipment.
    b. Information about major acquisitions or divestitutures.
    c. The management discussion and analysis.
    d. A summary of the firm's accounting policies.

8. What type of audit report indicates that the financial statements have not been presented fairly?
    a. A disclaimer of opinion.
    b. An unqualified report.
    c. A qualified report.
    d. An adverse opinion.

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    b. A disclaimer of opinion.
    c. A qualified report.
    d. An adverse opinion.

10. What does Section 404 of the Sarbanes-Oxley Act of 2002 require?
    a. The external auditors must create an adequate internal control structure for the firm being audited.
    b. The external auditors must approve of all internal auditors hired by a firm.
    c. The inclusion of an internal control report in the annual report.
    d. The external auditors need to perform internal audit services.

11. Why does the management discussion and analysis help the analyst?
    a. It contains information that cannot be found in the financial data.
    b. It provides predictions of all future financial statement numbers.
    c. It outlines the accounting choices made by the firm.
    d. It explains the market valuation of the firm's stock.

12. Which of the following items would not be discussed in the management discussion and analysis?

a. Commitments for capital expenditures.
b. The market value of all assets.
c. The internal and external sources of liquidity.
d. A breakdown of sales increases into price and volume components.

13. What item is probably the least useful when analyzing financial statements?

a. Management discussion and analysis.
b. The notes to the financial statements.
c. The statement of cash flows.
d. Public relations materials.

14. What document is required by the SEC to solicit shareholder votes?

a. Proxy statement.
b. Five-year summary.
c. Shareholders' letter.
d. Prospectus.

15. What types of information cannot be found in the financial statements?

a. Details about officer and employee retirement, pension, and stock option plans.
b. Pending legal proceedings.
c. Reputation of the firm, morale of employees and prestige in the community.
d. Disclosures about segments of an enterprise.

16. How are revenues and expenses recognized under the accrual basis of accounting?

a. Revenues are recognized when cash is received and expenses are recognized when cash is paid.
b. Revenues and expenses are recognized equally over a twelve month period.
c. Revenues and expenses are recognized based on the choices of management.
d. Revenues are recognized in the accounting period when the sale is made and expenses are recognized in the period in which they relate to the sale of the product.

17. Which of the following statements is true?

a. GAAP-based financial statements are prepared according to the "cash" rather than the "accrual" basis of accounting.

b. Accounting choices and estimates can have a significant impact on the outcome of financial statement numbers.

c. The accrual method means that the expense is recognized after the cash is paid out.

d. The purpose of the accrual method is to attempt to "match" assets with liabilities in appropriate accounting periods.

18. In what industries would it be expected that companies would spend a significant amount on research and development activities?

a. Health.

b. Clothes retailer.

c. Auto.

d. Both (a) and (c).

19. Which of the following items is NOT discretionary in nature?

a. Union wages.

b. Repairs and maintenance.

c. Research and development.

d. Advertising.

20. Which of the following could be detrimental to a firm's sales and earnings?

a. Using the matching principle when recording revenues and expenses.

b. Deferring repairs and maintenance on equipment.

c. Investing in research and development.

d. Increasing discretionary expenses.

For each of the following items indicate where you would most likely find the information.

a. Balance sheet.

b. Income statement.

c. Statement of stockholders' equity.

d. Statement of cash flows.

e. Notes to the financial statements.

f. Auditor's report.

g. Management's discussion and analysis.

21. Revenues.

22. Detailed information about the term, cost and maturity of debt.

23. Changes to the company's equity accounts.

24. An unqualified opinion.

25. Assets.

26. Attestation to the fairness of financial statements.

27. Discussion of the company's liquidity.

28. Cash inflows from investing activities.

29. A breakdown of sales increases into price and volume components.

30. Summary of significant accounting policies.

Short Answer

1. Write a short essay explaining the importance of financial statements and their accompanying notes.

2. List and describe the four basic financial statements included in a corporate annual report.

3. Discuss the similarities and differences between a company's Form 10-K and an annual report created especially to send to the stockholders.

4. Explain the importance of reading the notes to the financial statements.

5. Discuss the role of the SEC, the FASB, and the IASB.

6. Define the following terms related to the auditor's report: unqualified, qualified, adverse, and disclaimer of opinion.

7. According to the textbook "Internal auditors have become the 'rock stars' of the accounting industry." Explain what this means.

8. How did the Sarbanes-Oxley Act of 2002 change the regulatory model for auditors?

9. Explain how Congress addressed the issue of auditor independence in the Sarbanes-Oxley Act of 2002.

10. What regulations were included as part of the Sarbanes-Oxley Act of 2002 that should encourage CEOs and CFOs to act ethically?

11. Explain what types of information can be learned from the management discussion and analysis about liquidity? capital resources? operations?

12. What types of information are necessary to evaluate a company but cannot be found in the financial statements?

13. How can management affect the quality of financial statements?

14. What are discretionary items and why are they important to the operating success of a firm?

Solutions - Chapter 1

True-False

1. T	6. T	11. F	16. T	21. F
2. F	7. F	12. T	17. F	22. T
3. T	8. F	13. F	18. T	23. F
4. F	9. F	14. T	19. T	24. T
5. T	10. T	15. T	20. F	25. T

Multiple Choice

1. b	6. b	11. a	16. d	21. b	26. f
2. c	7. c	12. b	17. b	22. e	27. g
3. a	8. d	13. d	18. d	23. c	28. d
4. d	9. a	14. a	19. a	24. f	29. g
5. d	10. c	15. c	20. b	25. a	30. e

Short Answer

1. Financial statements and their accompanying notes contain a wealth of useful information regarding the financial position of a company, the success of its operations, the policies and strategies of management, and insight into its future performance. The objective of the financial statement user is to find and interpret this information to answer questions about the company, such as the following:

- Would an investment generate attractive returns?
- What is the degree of risk inherent in the investment?
- Should existing investment holdings be liquidated?
- Will cash flows be sufficient to service interest and principal payments to support the firm's borrowing needs?
- Does the company provide a good opportunity for employment, future advancement, and employee benefits?
- How well does this company compete in its operating environment?
- Is this firm a good prospect as a customer?

2. The balance sheet shows the financial position—assets, liabilities, and stockholders' equity—of the firm on a particular date, such as the end of a quarter or a year.

The income statement presents the results of operations—revenues, expenses, net profit or loss and net profit or loss per share—for the accounting period.

The statement of shareholders' equity reconciles the beginning and ending balances of all accounts that appear in the shareholders' equity section of the balance sheet.

The statement of cash flows provides information about the cash inflows and outflows from operating, investing, and financing activities during an accounting period.

3. The annual report and the Form 10-K generally include the company's four financial statements, notes to the financial statements and other items such as the management's discussion and analysis, auditor's report, five-year summary of selected financial data and market data. The annual report may contain public relations material that the Form 10-K does not, such as colored photographs, charts and, a letter to the shareholders from the CEO. The Form 10-K presents information in a specific order as required by the SEC that may not be included in an annual report created separately.

4. The notes to the financial statements are an integral part of the financial statements and must be read to thoroughly understand the statements. The notes include important information such as a summary of the firm's accounting policies and any changes to those policies during the reporting period, details about particular asset, liability, and equity accounts, major acquisitions or divestitures, officer and employee retirement, pension and stock option plans, leasing arrangements, the term, cost, and maturity of debt, pending legal proceedings, income taxes, contingencies and commitments, quarterly results of operations, and operating segments.

5. The SEC regulates U. S. companies that issue securities to the public and requires the issuance of a prospectus for any new security offering. The SEC also requires regular filing of annual reports, quarterly reports and other reports depending on particular circumstances. Congress has given the SEC authority to set accounting policies, although the SEC has largely delegated the role of rulemaking to the FASB.

The FASB is a private sector organization. The board issues rules and interpretations of those rules after a lengthy deliberation process. The board has no authority to enforce its rules, however, the SEC and FASB work closely and the SEC has generally enforced the rules that the FASB writes.

The role of the IASB is to work toward creating a set of international generally accepted accounting principles that will have worldwide acceptance in our global society. This would allow companies to list securities in any market without having to prepare multiple sets of financial statements.

6. An unqualified report states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows for the accounting period, in conformity with GAAP. A qualified report reveals a departure from GAAP. An adverse opinion is rendered when the departure from GAAP affects numerous accounts and financial statements so that the financial statements have not been presented fairly in accordance with GAAP. A disclaimer of opinion means the auditor cannot evaluate the fairness of the financial statements and therefore expresses no opinion on them.

7. Internal auditors have become the "rock stars" of the accounting industry as a result of the Sarbanes-Oxley Act of 2002 (SOX). Section 404 of the act requires companies to include in their annual reports a statement regarding the effectiveness of internal controls and the disclosure of any material weaknesses in a firm's internal controls system. This requirement has greatly boosted the need for internal auditors and SOX compliance specialists, but more importantly, has enhanced the value of the internal audit function within companies, as businesses have strengthened internal controls in response to SOX.

8. Prior to the passage of the Sarbanes-Oxley Act of 2002, auditors followed a self-regulatory model. Title I of the act established the Public Company Accounting Oversight Board (PCAOB), a private, nonprofit organization, which has been given the authority to register, inspect, and discipline auditors of all publicly owned companies; however, the SEC appoints the board members and has ultimate oversight of the PCAOB. In addition, the PCAOB now has the authority to write auditing rules, quality control and ethics standards.

9. Title II of the Sarbanes-Oxley Act of 2002 addresses the area of auditor independence, prohibiting audit firms from providing certain nonaudit services when conducting an external audit of a firm. Prohibited services include bookkeeping, design and implementation of financial information systems,

valuation and appraisal services, actuarial services, internal audit services, management or human resource functions, and broker, dealer, or investment banking services. Title II also encourages auditor independence by requiring the rotation of audit partners every five years if the audit partner is the primary partner responsible for a particular audit client. Another issue relating to auditor independence occurs when a company hires its chief financial officer (CFO) or other finance personnel from the ranks of the external audit firm. Section 206 of Title II inserts a one-year waiting period before an employee from the external audit firm may go to work for a client in the position of CEO, CFO, controller or any equivalent executive officer position, any financial oversight role and any person preparing financial statements.

10. Titles III and IV of the Sarbanes-Oxley Act of 2002 focus on corporate responsibility while Title IX attaches harsher penalties for violations. Section 302 requires that the chief executive officer and the chief financial officer of a publicly owned company certify the accuracy of the financial statements. An officer who certifies a report that is later found to be inaccurate could face up to $1 million in fines and/or a jail sentence of up to 10 years according to Section 906. These two sections work in conjunction with Section 404 (discussed previously) to encourage CEOs and CFOs to take responsibility for strong internal controls to prevent accounting fraud and financial statement misrepresentation.

11. The management discussion and analysis includes a discussion of the favorable and unfavorable trends and significant events or uncertainties in the areas of liquidity, capital resources, and results of operations. With regard to liquidity the analyst can expect to find a discussion of the internal and external sources of liquidity and any material deficiencies in liquidity and how they will be remedied. The discussion of capital resources should include commitments for capital expenditures, the purpose of such commitments, and expected funding sources, as well as anticipated changes in the mix and cost of financing resources. Information about the results of operations should include unusual or infrequent transactions that affect income from continuing operations, events that cause material changes in the relationship between costs and revenues, and a breakdown of sales increases into price and volume components.

12. Some of the items needed to evaluate a company that are missing from the financial statements are intangibles such as employee relations with management, morale and efficiency of employees, the reputation of the firm with its customers, its prestige in the community, the effectiveness of management, provisions for management succession, and potential exposure to changes in regulations such as

environmental or food and drug enforcement. Publicity in the media also affects the public perception of the firm and can impact the financial performance of the company.

13. Management has considerable discretion within the overall framework of GAAP, allowing for the potential manipulation of the financial statement numbers. The potential exists for management to manipulate the bottom line and other accounts in the financial statements. Although accounting rules provide guidelines helpful in making accounting allocations, these rules are not always precise. The timing of revenue and expense recognition can be based on arbitrary managerial decisions. Management may choose to cut costs in critical areas such as repairs and maintenance, research and development, advertising, and capital expansion with the sole purpose of increasing the bottom line, but at the expense of long-term profitability in the firm.

14. Discretionary expenses are those items that management exercises control with regard to the budget level and timing of the expenditures. Examples of discretionary expenses include repair and maintenance of machinery and equipment, marketing and advertising, research and development, and capital expansion. Each choice regarding these discretionary items has both an immediate and a long-term impact on profitability, perhaps not in the same direction. A company might elect to defer plant maintenance in order to boost current period earnings; ultimately, the effect of such a policy could be detrimental. For some industries, such as beverages and retail marketing, advertising and marketing expenditures are essential to gaining and maintaining market share. Research and development can be critical for ongoing success of industries such as computing and electronics, health and auto.

The financial analyst should carefully scrutinize management's policies with respect to these discretionary items through an examination of expenditure trends (absolute and relative amounts) and comparison with industry competitors. Such an analysis can provide insight into a company's existing strengths and weaknesses and contribute to an assessment of its ability to perform successfully in the future.