FINAL EXAM

Course # 141003
Profits You Can Trust

based on the book:

Profits You Can Trust Spotting & Surviving Accounting Landmines

by: H. David Sherman, S. David Young, & Harris Colling (2003)

Accounting & Auditing

This exam sheet is made available for your convenience in answering questions while offline. Please note that you will still need to enter your answers on the online exam sheet for grading. Instructions are provided at the end of this document.

Chapter 1 - Profits You Can Trust - and the Profits You Can't

1. Recent cases of fraudulent reporting bore warning signs missed by investors.

   ☐ TRUE

   ☐ FALSE

2. Outright fraud (fiction) is far more difficult to detect than aggressive, self serving, or misleading accounting judgments.

   ☐ TRUE

   ☐ FALSE

3. Fiduciaries, who have a responsibility to protect the investing public, include:

   ☐ corporate directors

   ☐ legal and accounting professionals

   ☐ securities analysts and investment bankers

   ☐ all of the above

4. Proforma profits have been referred to as "earnings with all the bad stuff taken out".

   ☐ TRUE

   ☐ FALSE

5. Flexibility is both the genius and the greatest vulnerability of US accounting.

   ☐ TRUE

   ☐ FALSE

6. Under the current system of accounting, many corporate managers, directors, lawyers, analysts, lenders, and auditors have powerful incentives to ignore or abet deceptive financial reporting.

☐ TRUE

☐ FALSE

7. A manager may distort its company's financial results in order to:

☐ maintain the company's access to capital markets

☐ meet lending requirements

☐ gain an edge in recruiting

☐ all of the above

8. Dishonest financial reporting drives investors away from the stock market.

☐ TRUE

☐ FALSE

9. As long as there have been accounting systems, there have been accounting games.

☐ TRUE

☐ FALSE

10. This type of company is more likely to push the accounting envelope and manipulate earnings:

☐ companies in extreme legal and regulatory environments

☐ companies with simple ownership and financial structures

☐ high profile glamour companies with extreme press coverage

☐ none of the above

Chapter 2 - Landmines: Where to Look

11. One revenue inflating trick of Enron was to report the entire amount of a trading transaction as revenue instead of reporting the actual commission.

- [ ] TRUE
- [ ] FALSE

12. Accounting estimates should be based on:

- [ ] historical data available
- [ ] reasonable assessments of the future
- [ ] other relevant considerations
- [ ] all of the above

13. A red flag to Enron investors was when accounts receivable increased by 65% while its allowance for doubtful accounts fell 50%.

- [ ] TRUE
- [ ] FALSE

14. Mark to Market accounting is a reasonable way to value securities as long as there is an active market for the securities.

- [ ] TRUE
- [ ] FALSE

15. A key factor supporting the legitimacy of an SPE is that it be independently managed.

- [ ] TRUE
- [ ] FALSE

16. The existence of risk is a sign of a poorly run company.

- [ ] TRUE

☐ FALSE

17. A vague and confusing discussion of a company's related party transactions could indicate that the company has something to hide.

☐ TRUE

☐ FALSE

18. Changes in key financial ratios often signal accounting games going on beneath the surface.

☐ TRUE

☐ FALSE

Chapter 3 - Revenue Recognition: What Is a Sale, And When Do You Book It?

19. Manipulation of financial results usually begins with revenue recognition.

☐ TRUE

☐ FALSE

20. The following is NOT a requirement for properly recognizing revenue:

☐ the revenue must be earned

☐ collection must be reasonably certain

☐ the transaction has been properly recorded

☐ all of the above are requirements for properly recognizing revenue

21. Management discretion with regard to revenue recognition includes both 'when' to recognize revenue and 'what' amount to recognize.

☐ TRUE

☐ FALSE

22. Priceline.com claimed that 'grossing up' sales properly recognized revenue as Priceline.com was the 'merchant of record' which meant they assumed all the risks of ownership.

- [ ] TRUE
- [ ] FALSE

23. Aggressive revenue recognition practices employed by MicroStrategy violated which accounting principle:

- [ ] matching
- [ ] valuation
- [ ] full disclosure
- [ ] historical cost

24. Xerox was able to overstate revenue and income for 1997 through 2000 by manipulating which calculation:

- [ ] amortization of intangible assets
- [ ] EBITDA
- [ ] contingent liability calculations
- [ ] present value calculations of leased equipment

25. Capacity swaps are a 'sale' of unused fiber optic capacity between telecom companies.

- [ ] TRUE
- [ ] FALSE

26. A game played by telecoms involves recording revenue for the sale of fiber optic capacity to other telecoms while capitalizing (i.e. not expensing) the offsetting purchase of capacity.

- [ ] TRUE
- [ ] FALSE

27. Percentage of completion is an accounting practice which allows companies to recognize revenue gradually over the life of a long term project.

    - [ ] TRUE
    - [ ] FALSE

28. One time gains, such as gains from the sale of real estate, should be segregated from recurring revenue on the income statement.

    - [ ] TRUE
    - [ ] FALSE

Chapter 4 - Provisions and Reserves: When Revenue Games Aren't Enough

29. In the banking world, the chances of a new merger or acquisition increase as a bank's merger reserve is depleted.

    - [ ] TRUE
    - [ ] FALSE

30. As a general rule, companies are eager to highlight reserves as they are reversed, but are less eager to highlight reserves when created.

    - [ ] TRUE
    - [ ] FALSE

31. Items that might be included in comprehensive income include:

    - [ ] unrealized gains / losses on investments in financial securities
    - [ ] gains / losses on derivative transactions used to hedge risk
    - [ ] gains / losses incurred in translating the financial results of a subsidiaries from local currency to the parent company's currency
    - [ ] all of the above

32. Gains or losses from currency translation are reported on the income statement if the subsidiary's functional currency is the US dollar.

☐ TRUE

☐ FALSE

33. Management determines if a subsidiary's functional currency is the local currency or the US dollar.

☐ TRUE

☐ FALSE

34. Because pension accounting is so complex, management has great opportunity to 'tweak' the numbers.

☐ TRUE

☐ FALSE

Chapter 5 - A Landscape of Hazard: The New World of Business Risk

35. Financial risk is the risk that a company may become insolvent.

☐ TRUE

☐ FALSE

36. The first step towards prudent management of financial risk is full disclosure and quantification of all financial obligations.

☐ TRUE

☐ FALSE

37. The single biggest hazard with regard to risk for any corporation and its shareholders, creditors and employees is:

☐ off-balance sheet financing

☐ derivatives

☐ other forms of risk

☐ none of the above

38. Green Tree's greatest sin was:

☐ making loans to shaky borrowers

☐ miscalculating customer prepayment and default rates

☐ failure to disclose clearly to investors that it remained liable for loans it had supposedly sold to the SPE

☐ none of the above

39. A company's line of credit is a classic example of a contingent liability.

☐ TRUE

☐ FALSE

40. Derivatives are likely to be used by:

☐ multinational companies

☐ manufacturing companies dependent on a steady stream of raw materials

☐ companies with borrowing costs subject to interest rate fluctuations

☐ all of the above

41. The practice of marking energy derivatives to market as done by Enron is still acceptable practice in the US.

☐ TRUE

☐ FALSE

42. Recent estimates put the pension fund shortfall in corporate America at hundreds of billions of dollars.

☐ TRUE

☐ FALSE

43. The federal Pension Benefit Guaranty Corporation (PBGC) has the authority to conduct a pension plan audit on a corporation and demand immediate remedy of underfunding.

☐ TRUE

☐ FALSE

Chapter 6 - Goodwill Hunting: How to Tell Hard Assets from Hot Air

44. In order to be deemed an asset. A resource must meet this criteria:

☐ it must be of future value to the company

☐ the company must own the resource or at least have exclusive ownership privilege

☐ the resource must be measured, quantified, and expressed in some currency

☐ all of the above

45. Generally, software development companies must capitalize and subsequently amortize software development costs until the point at which a workable prototype is produced. After that point, the development costs must be expensed.

☐ TRUE

☐ FALSE

46. Management determines at what point software development costs can be capitalized, but auditors must agree.

☐ TRUE

☐ FALSE

47. Goodwill is an intangible asset created when one company acquires another.

☐ TRUE

FALSE

48. Prior to the FASB interpretation released in 2001, no goodwill was recognized under the pooling of interests accounting for business combinations because the combination was considered a true merger rather than an acquisition.

    TRUE

    FALSE

49. According to the 2001 FASB pronouncement, goodwill is only written down when 'impaired', that is, when its value has declined significantly.

    TRUE

    FALSE

50. Trademarks, patents and copyrights must be valued as a part of goodwill and amortized over their estimated useful lives.

    TRUE

    FALSE

51. In-process R&D should be capitalized and subsequently amortized.

    TRUE

    FALSE

52. In-process R&D write offs are fertile ground for accounting mischief.

    TRUE

    FALSE

53. The annual valuation and analysis of goodwill may result in an increase and 'write up' of the value of goodwill.

    TRUE

    FALSE

54. Shamu (yes, the whale) has been depreciated over the remainder of his/her estimated lifespan.

- [ ] TRUE
- [ ] FALSE

Chapter 7 - The (Inner) Circle Game: Ripping Off Shareholders with Related-Party Transactions

55. Mechanisms used to avoid scandalous related party transactions may include:

- [ ] company control by a single person, group of persons or single entity
- [ ] a transparent cash management system
- [ ] a substantial number of directors with no ties to the company except their board memberships
- [ ] all of the above

56. Red flags which may identify hidden related party transactions include:

- [ ] loans with no due date or formal terms of repayment
- [ ] non monetary exchanges of property for similar property
- [ ] purchases of assets at prices in excess of fair market value
- [ ] all of the above

Chapter 8 - The Measure of Business Performance: Comparisons and Benchmarks

57. The accounting treatment of goodwill is a good example of how International Accounting Standards (IAS) differ from Generally Accepted Accounting Principles (GAAP).

- [ ] TRUE

☐ FALSE

58. The ratio of net income to sales is known as:

☐ return on equity

☐ asset turnover

☐ operating margin

☐ net profit margin

Chapter 9 - Let's Make up Some Numbers: EBITDA, Pro Forma Earnings, and Stupid Cash Tricks

59. EBITDA is an extremely accurate measure of cash flows.

☐ TRUE

☐ FALSE

Chapter 10 - Fair Value Toward Trustworthy Corporate Reporting

60. The International Accounting Standards Board (IASB) approach to accounting:

☐ is principle based

☐ adopts a 'less is more' attitude

☐ requires companies and auditors to consider whether the accounting contemplated is consistent with the spirit of a particular underlying principle

☐ all of the above

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